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Part III

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Minerals Management Service
Bureau of Land Management

30 CFR Parts 202, 203, 206, 207, 210, and 241

43 CFR Parts 3100 and 3160

Revision of Oil Product Valuation Regulations and Related Topics; Final Rule

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DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Parts 202, 203, 206, 207, 210, and 241

Bureau of Land Management

43 CFR Parts 3100 and 3160

Revision of Oil Product Valuation Regulations and Related Topics

AGENCY: Minerals Management Service and Bureau of Land Management, Interior.

ACTION: Final rule.

SUMMARY: This rulemaking provides for the amendment and clarification of regulations governing valuation of oil for royalty computation purposes. The amended and clarified regulations govern the methods by which value is determined when computing oil 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, (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, Minerals Management Service (MMS); 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 January 15, 1987, 52 FR 1858, the Minerals Management Service (MMS) of the Department of the Interior issued a notice of proposed rulemaking to amend the regulations governing the valuation of oil 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 over 100 written comments. In addition, public hearings were held in Lakewood, Colorado, on March 4, 1987, and in New Orleans, Louisiana, on March 17, 1987. Sixteen persons made oral presentations at those hearings.

Because of the complexity of the regulations, and in accordance with MMS's understanding with Congress, MMS issued a Further Notice of Proposed Rulemaking on August 17, 1987 (52 FR 30826), 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* dated June 27, 1987, at 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, September 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 39846, October 23, 1987). Public comments were received for 30 days. Over 25 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 that were changed. All comments were reviewed and considered in drafting the final rule.

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 January 1987. Based on its review, MMS hereby adopts final regulations governing the valuation of oil from Federal and Indian leases. These regulations will apply prospectively to production on or after the effective date specified in the **EFFECTIVE DATE** section of this preamble.

II. Purpose and Background

The MMS is revising the current regulations regarding the valuation of oil to accomplish the following:

(1) Clarification and reorganization of the existing regulations at 30 CFR Parts 202, 203, 206, 207, 210, 241, and 43 CFR Parts 3100 and 3160.

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

(3) Placement of the oil 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 lease production.

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

Structurally, these regulations include the reorganization of Parts 202, 203, 206, 207, 210, and 241. Each part is reorganized by redesignating "Subpart B—Oil and Gas, General" as "Subpart B—Oil, Gas, and OCS Sulfur, General"; "Subpart C—Oil and Gas, Onshore" as "Subpart C—Federal and Indian Oil"; and "Subpart D—Oil, Gas, and Sulfur, Offshore" as "Subpart D—Federal and Indian Gas."

Also, a number of sections are renumbered and/or moved to a new subpart. In addition, new §§ 202.51, 202.101, 206.103, 206.104, 207.1, 207.2, 207.5, and 210.55 are added to the appropriate parts and subparts.

Current § 206.104 is an onshore operational regulation which is under the jurisdiction of the Bureau of Land Management (BLM). This section is being redesignated as 43 CFR 3162.7-4, and the existing § 3162.7-4 is being redesignated as § 3162.7-5. Also, in order to avoid any inconsistencies between these final rules and the BLM rules, 43 CFR 3103.3-1 is being revised by deleting subsections (c) and (d) and

redesignating existing subsection (3) as new subsection (c).

This rule applies prospectively to production on or after the effective date specified in the EFFECTIVE DATE section of this preamble. It supersedes all existing oil 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 Notice to Lessees (NTL's) issued over past years. Specific guidelines governing reporting requirements consistent with these new oil 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:	
1. Subpart Titles	
The titles of all subparts in Parts 202, 203, 206, 207, 210, and 241 have been redesignated, retitled, or added as necessary, to reflect the following titles: (Subparts are reserved under certain Parts). Subpart A—General Provisions Subpart B—Oil, Gas, and OCS Sulfur, General Subpart C—Federal and Indian Oil Subpart D—Federal and Indian Gas Subpart E—Solid Minerals, General Subpart F—Coal Subpart G—Other Solid Minerals Subpart H—Geothermal Resources Subpart I—OCS Sulfur	The subparts were retitled in order to organize them by a commodity (oil vs. gas, etc.) rather than emphasizing location (onshore vs. offshore) as was done formerly.
2. Part 202	
Sections 202.150, 202.151, and 202.152 under old Subpart D are redesignated as § 202.100, under new Subpart C and §§ 202.53, and 202.52, under new Subpart B, respectively	This action is the result of retitling of the subparts
3. Part 203	
Section 203.150 under old Subpart D is redesignated as § 203.50 under new Subpart B. Section 203.200 under old Subpart E is redesignated as § 203.250 under new Subpart F.	This action is the result of retitling of the subparts.
4. Part 206	
Sections 206.300 and 206.301 under old Subpart G are redesignated as §§ 206.350 and 206.351 under new Subpart H, respectively	This action is the result of retitling of the subparts
Section 206.104 under old Subpart C is redesignated under Title 43 CFR as § 3162.7-4. Existing § 3162.7-4 is redesignated as § 3162.7-5	This section addresses a BLM onshore operations issue which properly belongs in 43 CFR.
5. Part 210	
Sections 210.300 and 210.301 of old Subpart F are redesignated as §§ 210.350 and 210.351 under new Subpart H, respectively	This action corresponds to the redesignation of Subpart F as Subpart H
Section 241.100 under old Subpart C is redesignated as § 241.53 under new Subpart B	This action is the result of retitling of the subparts
II. Deletions:	
1. Part 202	
Sections 202.100 through 202.103 are removed from old Subpart C	These sections cover activities now governed by BLM
2. Part 203	
Section 203.100 is removed from old Subpart C	This section covers an activity now governed by BLM operations personnel
3. Part 206	
Section 206.103 is removed from old Subpart C	This section has been rewritten and relocated in the regulations as Subparts C and D of Part 206.
4. Part 207	
Sections 207.1, 207.2, 207.5, 207.6 and 207.7 are removed	The subject matter of these sections is addressed elsewhere in the regulations. They are, therefore, redundant and have been removed to avoid confusion.
5. Part 210	
Sections 210.100 through 210.105, and §§ 210.150 and 210.151 are removed from old Subparts C and D, respectively	These requirements of §§ 210.100 and 210.101 are now covered by Part 207, as amended. Sections 210.102, 210.103 and 210.104 are no longer applicable (these forms are no longer in use). Section 210.105 has been replaced by new § 210.55.
6. Part 241	
Section 241.10 under Subpart A is removed and reserved. Paragraph (c) of new § 241.53 (formerly § 241.100) is removed from new Subpart B.	The forms identified in § 241.53(c) and § 241.10 are no longer applicable.
III. Additions.	
1. Part 202	
Sections 202.51 and 202.101 are added to new Subparts B and C	These new sections provide oil valuation standards and procedures
2. Part 206	
Sections 206.103 and 206.104 are added to new Subpart C	These new sections provide oil valuation standards and procedures.
3. Part 207	
Sections 207.1, 207.2, and 207.5 are added to new Subpart A	These new sections reference the definitions in Part 206 and set forth certain recordkeeping requirements.
4. Part 210	
Section 210.55 is added	This will replace § 210.105.

The rules in § 206.100 expressly recognize that where the provisions of any Indian lease, or any statute or treaty affecting any Indian lease, are inconsistent with the regulations, then the lease, statute, or treaty will govern to the extent of the inconsistency. The same principle applies to Federal leases.

A separate oil definitions section applicable to the royalty valuation of oil 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. Because the definitions are specific to these parts, they may not necessarily conform to definitions of the same terms in other Federal agencies' regulations.

III. Response to General Comments Received on Proposed Oil Product Valuation Regulations and Related Topics

The notice of proposed oil valuation regulations was published in the Federal Register on January 15, 1987 (52 FR 1858). This was followed by a Further Notice of Proposed Rulemaking (52 FR 30826, August 17, 1987), and a Second Further Notice of Proposed Rulemaking (52 FR 39846, October 23, 1987). Over 150 comments were received from interested persons including Indian lessors, the States, and industry.

The commenters included industry/trade groups, State, local, and Federal governmental entities, Indian Tribes or allottees, a State/Tribal association, and an individual.

The MMS received many diverse comments on the principles underlying

the proposed valuation methodology. These comments did not address specific sections of the proposed regulations. The respondents generally comprised two groups, with industry generally on one side and States and Indians on the opposing side. The general comments were categorized into five more-or-less interrelated issues: (1) Acceptance of gross proceeds under an arm's-length contract, or the benchmark, 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.

(1) Acceptance of gross proceeds as the value for royalty purpose

Industry commenters generally agreed that the basic premise underlying the proposed rulemaking is sound because value is best determined by the interaction of competing market forces. However, State and Indian commenters disagreed, particularly objecting to the concept of accepting gross proceeds received under arm's-length transactions as representative of market value. The commenters were concerned that the acceptance of gross proceeds, without additional testing of its validity, could lead to manipulation of pricing schedules, an erosion of payors' accountability and, in general, would fail to protect the interests of the lessor. Many pointed out that gross proceeds has historically not been considered equivalent to market value, citing various legal opinions in support. In view of this, State and Indian commenters declared that royalty value should be equivalent to the highest price posted for like-quality production in a field or area.

MMS Response: The MMS's experience demonstrates that the highest price posted in a given field does not necessarily reflect a bona fide offer to purchase, nor does it reflect that significant quantities of oil are being purchased at that price. In these regulations, MMS generally will assess royalty on the value to which the lessee is legally entitled under its arm's-length contract. MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value. For many Indian leases, MMS will also require consideration of the highest price paid for a major portion of production in accordance with the lease terms.

To assure that gross proceeds represent market value, and thus insure accountability, Indian and State commenters suggested that reported gross proceeds values should be tested/validated by using the net-back (work-back) procedure as an independent crosscheck. They also suggested that royalty reporting should be routinely monitored by using this procedure.

MMS Response: The MMS believes that gross proceeds under arm's-length contracts are representative of market value. However, MMS will continue to monitor value determinations under its regulations to ensure that those determinations yield reasonable values. To routinely perform labor-intensive net-back calculations is impractical.

Some State respondents doubted that the benchmark hierarchy system for determining values under non-arm's-length transactions could be properly applied because of the system's complexity and because the valuation procedure is predicated upon a payor's ability and willingness to identify a transaction as either arm's-length or non-arm's-length. They feared that industry might be reluctant to identify non-arm's-length transactions and thus merely declare gross proceeds as value, thereby placing the burden of proper finding upon MMS during audit.

MMS Response: The MMS supports the benchmark system. Most of industry, those who report under the system, believe it to be a workable system. In general, industry can identify its own arm's-length contracts based on standards established in these regulations and it is in its best interests not to classify non-arm's-length transactions as arm's-length because of the threat of both high interest costs and possible penalties. However, MMS will use the audit process to verify that contracts which are claimed to be arm's-length satisfy all the standards of the definition, discussed in detail below.

(2) Deduction of Transportations Costs

Although industry commenters supported the proposed deductions for transportation costs, many of the respondents believed the allowable deductions were too restrictive, and one suggested that transportation allowances should be actual costs based on Federal Energy Regulatory Commission (FERC) tariffs or arm's-length transportation arrangements. However, comments from States and Indians objected to the allowances as being too liberal and unnecessarily open-ended by effectively granting the allowances regardless of need. They suggested that transportation deductions should be allowed only when transportation costs are necessary to the sale of the production, that transportation allowances should be limited to OCS production only, or that no deductions should be allowed, at least for tribal lands.

MMS Response: The MMS believes that costs incurred by a lessee to transport lease production to a delivery point off the lease increases its value and, therefore, is a recognized deduction. See the transportation allowance section of this preamble for further discussion.

(3) Legal Mandates and Responsibilities Toward Indians

Some State and Indian respondents questioned the legality of the proposed rulemaking, expressing their view that the proposed modifications, particularly with respect to arm's-length contracts and gross proceeds, are contrary to the intent of the valuation requirements of the Mineral Lands Leasing Act, 30 U.S.C. 181 *et seq.*, and the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. 1701 *et seq.*, and are a marked departure from historical valuation regulations and lease terms. Their basic argument is that the statutes require royalty based on the value of production, and a royalty clause based upon "value" is not satisfied by a valuation procedure based upon gross proceeds; in their opinion, value may be considerably higher than revenues from arm's-length transactions.

MMS Response: The regulations generally define value on the basis of market transactions, consistent with commonly held economic philosophy, rather than some arbitrary "value" which can be easily misconstrued, disputed, or misinterpreted. The MMS believes there is no conflict between the intent of the Mineral Lands Leasing Act, FOGRMA, and the valuation procedures being adopted herein.

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 (2d 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 purpose 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 these 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," in many instances, are 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.

The Indian commenters took particular exception to the proposed rulemaking, pointing out that the proposed valuation procedures based on gross proceeds are in conflict with the Secretary's duty under the Unallotted Indian Leasing Act of 1938 and the Indian Mineral Development Act of 1982 to ensure that tribes and allottees receive the maximum return for their property. They disagreed that gross proceeds represented market value, and thus believed they would not receive the maximum benefit accruable from production pursuant to statutes. One respondent suggested that the proposed regulations apply prospectively only to newly issued leases so that royalties owed to Tribes and allottees under existing regulations would not be diminished.

MMS Response: MMS believes the new valuation regulations, with the changes discussed in more detail below, are fully consistent with the Secretary's obligations to Indian lessors.

(4) Complexity and Obscurity of Regulations and Definitions

Some commenters believed that the proposed rulemaking generally was excessively complicated, leading to difficulty in interpretation. As a result, they believe the proposed rules fail to achieve the stated goals of simplification and providing certainty.

MMS Response: The MMS has endeavored to correct certain identified deficiencies in the final rulemaking. The regulations combine previous regulations, NTL's, orders, and internal policies. They will provide a single source for product value guidance which necessarily will be simpler and more comprehensive than the existing procedures.

(5) Economic Impacts

State and Indian commenters disagreed with MMS's statement that the proposed regulations would yield long-term benefits to royalty owners. Indian commenters, in particular, believed the proposed valuation rules would have a significant detrimental economic impact on Tribes and allottees. A detailed analysis of the economic impacts of the proposed rules was suggested by one commenter to support MMS's claim that the short-term effects on revenues would be limited.

MMS Response: The MMS believes that the regulations provide valuation criteria that will result in reasonable values and will create an atmosphere of certainty in royalty payments and thereby correct some of the royalty deficiencies encountered in the past.

The Further Notice of Proposed Rulemaking of August 17, 1987 (52 FR 30826), and the Second Further Notice of Proposed Rulemaking of October 23, 1987 (52 FR 39846), specifically requested comments on certain broad issues, and the Second Further Notice of Proposed Rulemaking also specifically requested comments on certain individual issues. Because the response to both the broad and specific issues were also addressed in the Preamble to the Final Gas Valuation Regulations published elsewhere in today's Federal Register, reviewers are directed to the responses provided in the Preamble to that rulemaking.

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 any of 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 1858, January 15, 1987) may be consulted for a full description of the purpose of those sections. For other sections, this preamble will address primarily the extent to which the final rule was changed from the proposal. Again, a complete discussion of the applicable sections may be found in the preamble to the proposed regulation.

Section 202.52 Royalties.

For purposes of clarity, one State commenter suggested that the word "royalty" be inserted before the words "rate specified", and the words "amount of royalty" be deleted and replaced with the words "royalty rate." This suggestion was made because some lessees have confused the computation of royalty rate and the computation of the amount of royalties due.

MMS Response: The MMS agrees that these suggested changes should be made for purposes of clarity and the final rule has been modified accordingly.

The MMS has removed from the final rules the two sections addressing the general responsibilities of MMS and lessees. All of these responsibilities are addressed in various provisions of 30 CFR and elsewhere. Thus, these sections were duplicative and, based on the comments received, caused confusion.

Section 202.100 Royalty on oil.

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 contact 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.

Industry commenters recommended that this section state that no permission is necessary to exempt from royalty any oil used for the benefit of the lease, either on-lease or off-lease, and including communitized or unitized areas. In addition, another industry commenter stated that where agency approval is necessary, this section should address the procedure to acquire such permission.

Some Indian commenters also recommended that any royalty-free use of oil be subject to prior approval to ensure that production from Indian leases is not disproportionately used in royalty-free operations. One Indian commenter objected to any off-lease use of oil that would be royalty free.

MMS Response: The royalty-free use of oil is an operational matter covered by the appropriate operating regulations of the BLM and MMS for onshore and OCS operations, respectively. The BLM requirements are governed by the provisions of Notice to Lessees and Operators No. 4A. 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 oil is warranted because most leases by their specific terms allow royalty-free use of oil and it is a matter which will be reviewed during audits to prevent abuse.

One industry commenter proposed that MMS consider expansion of § 202.100(b) to include appropriate royalty deductions for the oil equivalent cost of alternative fuels which may also be used for beneficial purposes on the lease.

MMS Response: This suggestion was not adopted. This issue is more properly directed to operational regulations, not value regulations, and is outside the scope of this rule. The MMS has included these provisions simply to reflect the general lease terms and regulatory provisions which prescribe the royalty obligation.

Proposed § 202.100(b), which addressed royalty-free use of oil 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 multiple leases may not be allocated to an individual lease without incurring a royalty obligation on a portion of the fuel.

A State commenter suggested changes designed to help end the confusion about the distinction between computing the royalty rate and computing the amount of royalties due. MMS has adopted some changes to the wording of §§ 202.100(a) and (b) for clarity.

Section 202.100(c) was proposed as § 206.100(d). A comment was received from industry suggesting the addition of the phrase "because of negligence of lessee" after the words "offshore lease," in order to be consistent with section 308 of FOGRMA.

MMS Response: This subpart addresses the valuation of oil which has been determined to be "avoidably lost," not the reason(s) for that determination. Determination of "avoidably lost" and "negligence" is a function of MMS OCS Operations for OCS leases and BLM for onshore Federal and Indian leases. The BLM's requirements are governed by the provisions of 43 CFR Part 3160 and Notice to Lessees and Operators No. 4A. The MMS's requirements are governed by 30 CFR Part 250. The addition of the recommended phrase, therefore, is considered inappropriate for inclusion in this rulemaking.

Section 202.100(d) requires royalties to be paid on insurance compensation for unavoidably lost oil. Several industry commenters stated that to require a lessee to pay royalties on any compensation received through insurance coverage or other arrangements for oil 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.

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 then 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.

The MMS has added at § 202.100(e) of the final rules a provision concerning production governed by a federally approved unitization or communitization agreement. Section 202.100(e) states that all agreement production attributable to a Federal or Indian lease in accordance with 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, § 202.100(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. For example, if a Federal lessee does not sell or otherwise dispose of its allocable share of unit production, then it will be sold or otherwise disposed of by other unit participants. If one of the unit participants other than the Federal lessee transports the oil to a terminal off the unit area under an arm's-length transportation agreement and then sells the oil under an arm's-length sales contract, the value, for royalty purposes, will be that person'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 person 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 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 subparagraph (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.

Some industry commenters also stated that the foreseeable results of this paragraph include: (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 subparagraph (2) which authorizes MMS to approve a royalty valuation method different from that prescribed by subparagraph (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 1,000 barrels of production. It is required to pay royalty on that volume. However, it only is able to sell 750 barrels that month. The lessee could request that MMS allow it to pay royalty on the remaining 250 barrels at its contract price.

The MMS recognizes that under most balancing agreements, a lessee who has under taken at some point will over take to balance its account. Since the lessee was required to pay royalties on the value of its allocated share when it under took, 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 subparagraph (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 206.100 Purpose and scope.

One industry commenter agreed with the concept that Indian Tribal and allotted leases be treated under the same oil valuation standards applied to Federal leases unless the specific lease terms require otherwise. That commenter also suggested that MMS support Indian Tribes and allottees, if requested, in marketing their royalty share of production. An Indian Tribe commenter asserted that it may be inconsistent to use the same oil valuation standards for Indian and Federal leases: "Because of the trust responsibility of the United States to maximize Indian royalties, it may be inconsistent to have Indian and Federal leases treated the same under this section, especially if the policy of Interior is to earn a reasonable and long-term maximum rate of return and revenues for all parties."

MMS Response: The MMS believes generally that maintaining a single set of oil valuation regulations that apply to both Federal and Indian lands (except leases on the Osage Indian Reservation) provides for consistency and certainty in the determination of the value of oil for all lands administered by the DOI and will result in obtaining a reasonable and appropriate rate of return to all parties concerned. However, because of the lease terms of many Indian leases, MMS has included in the rules some additional valuation standards applicable only to those Indian leases.

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

In accordance with paragraph (b) of this section, where the provisions of any statute, treaty, lease or settlement agreement are inconsistent with these regulations, the lease, statute, treaty or settlement agreement provision will govern to the extent of that inconsistency. This policy also applies to court decisions—regulatory revisions will be required to the extent of any inconsistency with the existing regulations, provided they are not ambiguous or unclear in their intent. Thus, MMS maintains the DOI's responsibility to Indians by assuring that the regulations do not supersede the authority granted by the lease, or violate provisions of a statute, treaty, or court decision.

Several Indian respondents commented on § 206.100(b). One suggested that the proposed rules should expressly recognize 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, then the lease, statute or treaty, or *court interpretation* would govern to the extent of the inconsistency."

Another commenter expressed the view that "caution should be exercised before stating that 'the lease * * * provision shall govern to the extent of that inconsistency.' Many Indian allottee and tribal leases are very old and were entered into when industry practices were very different than they are now. The parties to the lease may have understood the lease to incorporate standard industry practice at that time. For this reason, some provisions may have been omitted from the written instrument. It may be proper to interpret some of those unwritten provisions in light of today's standards, but it may be grossly unfair to the

royalty owner to so interpret others. One such example may be transportation costs. If transportation costs were not being deducted from royalties when the lease was entered into, transportation costs should not be deducted now, even though not mentioned in the lease. It is our conclusion that this should be considered and the regulations should make some mention of this consideration." Another commenter suggested including settlement agreements entered into to resolve administrative or judicial litigation because these agreements may vary from the rules.

MMS Response: Obviously, MMS will comply with court orders and judicial decisions which affect these regulations. It is well known, however, that court decisions often focus only on parts of issues, leaving those decisions open to interpretation. Furthermore, a court's jurisdiction can limit the applicability of its decision. It is for these reasons that MMS has elected not to include an express reference to court decisions or court interpretations in this or any other subpart of these regulations.

Contrary to the interpretation of this section by the second commenter, the regulations will not change any specific lease provisions. The MMS has included the suggested reference to settlement agreements.

Few comments were received concerning § 206.100(c). One from industry endorsed the recommendation of the Royalty Management Advisory Committee (RMAC) Oil Valuation Panel which proposes placing a limit on the time period during which MMS may conduct an audit on a lease. It asserted that such a limitation "encourages prompt action, assures the retention of appropriate records, and gives the lessee assurance that its current business will not be disrupted by examinations of very remote payments. We believe a 6-year limitation is reasonable for both MMS and the lessee."

The Indian respondent is concerned that "Although all royalty payments made to MMS will purportedly be subject to later audit and adjustment, MMS's past audit record does not reassure the tribes that all royalties due will be collected."

MMS Response: These regulations concern valuation procedures, not accounting functions. All MMS audits are subject to the requirements found at 30 CFR 217.50, which does not specify any time limit during which MMS may conduct an audit. Because the reference in § 206.100(c) is intended only to be a general reminder that royalty payments will be audited, the recommendation to place a time limit on audits was not adopted. 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. MMS will address the issue of audit closure elsewhere.

Several Indian commenters suggested that MMS should amend § 206.100(d) to specifically refer to the Secretary's trust responsibility to the Indians.

MMS Response: The MMS has made the suggested change.

The MMS received a comment from an Alaska Native Corporation stating that MMS should not make the new regulations applicable 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 § 206.100(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. The MMS does not intend that any rules adopted in this rulemaking would apply to production involving Alaska Native Corporation interests which occurred prior to the effective date of this rulemaking.

Section 206.101 Definitions.

"Allowance"—Comments were received on this paragraph from State entities, Indian Tribes, and a Federal agency. One State commenter pointed out that this definition appears to be inconsistent with the sections of the valuation regulations dealing with transportation allowances (§§ 206.104 and 206.105). The word "allowance" is defined in terms of being "authorized," "accepted" or "approved," whereas the regulations state that a transportation "allowance" can be deducted without prior approval. Their concern is that the definition should match the usage in the regulations. An Indian commenter stated 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*." A Federal agency comment stated that the definition is too liberal and would result in the Federal Government subsidizing oil companies' operation costs. They cited an example where a transportation allowance of as much as 50 percent could be granted for moving oil in lateral lines to off-lease measurement points; specifically, from wellheads to a Lease Automatic Custody Transfer (LACT) unit. One State commenter suggested that the definition is unnecessarily broad and recommended deleting the language "or an MMS-accepted or approved" as well as deleting the phrase "to a point of sale or point of delivery remote from the lease." This commenter also suggested adding the words "necessary and" before the word "reasonable." The rationale for making these changes is that there are other sections of the regulations that clarify "that MMS need not provide advance approval before a lessee could take an allowance." The "accepted or approved" language could be interpreted to suggest that "allowances are not subject to later adjustments by MMS after full audit, based on arguments that the allowance was accepted by MMS after receipt of the actual costs report under § 206.105(b)(2), or accepted under the terms of the regulations."

MMS Response: These regulations, in effect, "authorize" the lessees to deduct certain costs incurred for transportation from the value without prior approval. (See §§ 206.104 and 206.105). Allowances computed by the lessee shall be "accepted" by MMS subject to review and/or audit. The MMS has not included a definition of the phrase "remote from the lease" in the final rules. To eliminate any confusion, MMS has replaced this phrase with the phrase "off the lease." Thus, transportation off the lease, other than gathering, is subject to an allowance. The MMS has included an express statement in the final rule that transportation allowances do not apply to gathering costs. An industry group comment that the phrase "excluding gathering" be deleted was

rejected because MMS believes that gathering is a cost of making oil marketable, which must be borne exclusively by the lessee.

"Area"—A comment was received from industry addressing this definition as being imprecise and in need of specified limits in order to define how large an "area" can be. In addition, the commenter proposed that the definition should be clarified by inserting the phrase "or producing unit" after "oil and/or gas field."

MMS Response: The definition seeks to encompass a concept that is very difficult to describe. Narrowing its scope by describing it in terms of size will only establish an arbitrary basis for the definition. To avoid this, MMS elected to retain the definition as proposed.

"Arm's-length contract"—A large number of comments were received on this definition from industry, Indians, a State/Tribal association, States, and a Federal agency. The proposed definition of "arm's-length contract" generated a significant number of comments because it is, as one commenter noted, the "* * * linchpin of the benchmark system * * *." Because of the importance of this concept, it is not surprising that several commenters disagreed with the definition, either in part or in its entirety. Indeed, one State commenter described the reliance on the concept of "arm's-length" as a method of determining value to be "both inefficient and inappropriate" and suggested deleting the definition altogether. The majority of commenters, however, focused on what they considered to be flaws in the originally proposed definition and the specific recommendations they considered necessary to conclusively address those flaws.

One Indian commenter suggested that the basic flaw in the definition is the assumption that the interests of the lessee and the lessor are identical. This commenter pointed out that the courts "have recognized that the interests of lessees and lessors often diverge. See, e.g., *Piney Woods Country Life School* v. *Shell Oil Company* 726 F.2d 225 (5th Cir. 1984), *cert. denied.*, 105 S. Ct. 1868, (1985), *Amoco Production Company* v. *Alexander*, 622 S.W. 2d 563, (Tex. 1981)." Another State commenter described the definition as "clearly deficient because it is limited to formal affiliation or common ownership interests between the contracting parties." The assumption that arm's-length contract prices reflect market value "ignores the fact that parties may have contractual or other relationships or understandings which would cause them to price oil below its value, especially if the benefit of the reduced royalty burden can be shared by means of the oil sales contract." This commenter believed that the lessee's and lessor's interests may not be the same, and that the royalties due lessors is viewed by many lessees as a cost to be minimized, not maximized. Another comment submitted by the State/Tribal association cited the following as an example of a situation where, although the parties are unaffiliated, the market value may be less than the arm's-length contract price: "Thus, for example, the price received by a lessee/producer who is a captive shipper of a single purchaser pipeline, albeit unaffiliated, will be accepted as the value, despite the fact that competing market forces are not operating. Even if audit revealed facts that would indicate that the sales price is suspect, the government would be bound under the proposed regulations to accept it if the parties were nominally unaffiliated. The MMS proposal would even foreclose the use of standard price checks, presently used * * * in * * * audit efforts, to assure that contract proceeds represent the statutory requirement of fair market value of production." One State commenter concluded that in its attempt to establish an "almost purely objective" test and provide for certainty in valuation, MMS has inadequately tried to justify "giving away the power to prevent manipulation of the public's royalties." Other State and Indian commenters claimed that the proposed definition, although it may be objective, remains "unworkable" mainly because it does not include any reference to "adverse economic interests" and "free and open market" nor would it serve as an effective audit tool. They urge MMS to use the definition first proposed by MMS to the RMAC because "that definition incorporates the common legal understanding of the term arm's-length—the existence of unaffiliated willing buyers and willing sellers of adverse economic interests operating in a free and open market—and is the only definition that can assure against valuation becoming an industry 'honor system.' "

One State commenter stressed that even though the inclusion of additional criteria ("adverse economic interest" and "free and open market") would increase subjectivity, "the appeals process is in place to provide protection against arbitrary decisions." State and Indian commenters specifically recommended that the proposed definition be replaced by the one proposed to RMAC by MMS in the draft regulations. That definition reads as follows:

> 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 interests 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.

One Indian Tribal commenter suggested that "MMS should derive a definition of oil value for royalty purposes (instead of what they consider would be a necessary, all-inclusive, lengthy definition of arm's-length contract) which is simple and which represents the true value of the production. The [commenter] submits that such a definition must be based on the highest price paid or posted for similar oil in the same field or area." Another commenter stressed that the definition limits the discretion of the Secretary to select whatever method he/she considers appropriate to determine the value of oil for royalty purposes.

A large number of industry commenters agreed that the definition of an "arm's-length contract" as "a contract or agreement between independent and nonaffiliated persons" is sound and appropriate. However, these same commenters (plus some Indian and State commenters) objected to the phrase in the proposed definition "or if one person owns an interest (regardless of how small), either directly or indirectly, in another person" as being too "restrictive." [1] The rationale for this position is that the phrase appears to defeat MMS's intent to use arm'slength contracts as the principal valuation method. Many industry commenters addressed the need to clarify the definition in order to insure that joint ventures, joint operating agreements, tax partnerships, and other relationships where the "interest" of one party in another is not one of beneficial control, are specifically excluded. As one of these commenters put it: "Similarly, 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.

[1] Several commenters used the word "restrictive" to mean that the language in the proposed definition regarding "if one person owns an interest (regardless of how small), either directly or indirectly, in another person" significantly restricts the number of situations where an arm's-length contract would actually exist. A few comments espoused this same position, yet they termed the definition as too "broad." As used in this discussion, MMS considers the word "restrictive" to represent the above-mentioned position, and the word "broad" to denote that the language of the definition is either too vague or not restrictive enough.

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. Such joint operations are often mandated and/or approved and sanctioned by the various governmental agencies having jurisdiction and supervision over the operations (i.e., communitization, unitization, and development plans; and joint bidding agreements). They do not establish joint marketing rights, or otherwise erode the competitive desire of each owner to achieve maximum value for its share of production." Several industry commenters also complained that the ownership by one party of one share of stock in another party would confer affiliated or non-arm's-length status to virtually all otherwise arm's-length transactions between the two parties. They further stated that this would be true even if the pension plan of one party holds one share of stock in the other party. One Indian commenter suggested that MMS would waste its efforts trying to determine ownership interest: "There is also a problem with using ownership interest 'regardless of how small' in the definition. There is no definition in the proposed regulations of 'owns an interest.' Would the ownership of one share of stock be considered owning an interest? Parameters must be set and adhered to. When MMS starts trying to determine ownership interests no matter how small, an endless quagmire will develop, and time and resources will be devoted to this determination when they would be better spent on MMS's other duties."

Another industry commenter pointed out that the proposed definition is inconsistent with the guidelines concerning beneficial control under generally accepted accounting principles, while a number of other industry commenters claimed that it eliminates certainty in valuation.

The majority of all the comments stress the need to replace the phrase "or if one person owns an interest (regardless of how small), either directly or indirectly, in another person" with a statement that specifies quantifiable limits that would be used to determine whether or not one party would be considered to have a controlling interest in another party. Nearly all of these comments recommended that MMS adopt the following language for the definition of control which has already been implemented by BLM as codified at 43 CFR 3400.0–5(rr)(3) (51 FR 43910, December 5, 1986):

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.

A few industry commenters recommended replacing the word "person" with the word "party" in the definition of arm's-length contract because they foresee that the use of the word "person" will "unnecessarily preclude contracts between joint ventures from qualifying as arm's-length." Similarly, one industry commenter suggested deleting the words "consortium" and "joint venture" from the definition for "person" ("party") for the same reason.

Finally, one industry commenter objected to "the implicit and explicit presumption throughout the Oil Proposal that proceeds actually received through affiliated sales are less than fair value. This presumption places an unfair, impractical, and impossible standard on a producer who, acting in its best economic interest, elects to sell to an affiliated entity. In this regard, a redefinition of the term "Arm's-Length Contract" is recommended to eliminate reference to and inclusion of de minimis relationships."

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). 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 requires 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 oil from a Federal or Indian lease will 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 believed 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 believed 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, discussed below. The MMS also believes that these sections satisfy the request that the rules prescribe that the lessee has the burden of proving nonaffiliation because 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 (e.g., 5 percent) 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"—Only a few comments were received on this proposed definition. All the comments focused on the portion of the definition which followed the first sentence. Generally, these comments suggested that the proposed definition limited the scope of MMS's authority, particularly with regard to Indian leases.

MMS Response: It is MMS's intention that the definition not be limited. Therefore, the final rule deletes everything following the first sentence of the proposed definition because the succeeding sentences were only intended to be explanatory.

"Condensate"—One industry comment advocated adding the phrase "beyond normal lease separation procedures" after the word "processing" in the first sentence of the definition in order to clarify that "liquid hydrocarbons resulting from normal lease separation procedures are condensate" whereas "processing," in this context, refers to more sophisticated facilities that are generally located off lease.

MMS Response: This definition has been retained intact in the final rule. However, a definition of the word "processing" has been added for clarification purposes at § 206.101.

"Contract"—A comment from a State commenter recognized that "as a matter of law, oral contracts are enforceable." This commenter recommends that the words "oral or" be deleted because they argue that "there is no way that the terms of such contracts can be adequately verified to assure that all of the consideration and benefits under it have been honestly detailed by the lessee under proposed § 207.4. Thus, the government, in a situation involving an oral contract, must assure itself that it has all of the information relevant to the transaction; reliance on the 'contract' document—drafted by one party only—would be insufficient."

MMS Response: The MMS has retained this definition as proposed because, in accordance with § 207.4, oral contracts negotiated by the lessee must be placed in written form and retained by the lessee. If the MMS believes that the written documentation is not a truthful representation of the actual terms of the sales agreements, the lessee may be liable for penalties for submitting false, inaccurate, or misleading data.

"Gathering"—MMS included in the draft final rule a definition of gathering as the movement of lease production to a central accumulation 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 (if authorized by the BLM or MMS operations authority). In most instances, gathering is a cost of production or marketing for which MMS will not grant any deduction.

The 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 offlease movement.

MMS Response: The definition has been retained intact. The operational regulations 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 purpose 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 many comments on the definition of "gross proceeds" from industry, States, Indian Tribes, and a State/tribal association.

One State agreed with the language of the proposed definition and supported its endorsement as follows: "Such a definition must be all inclusive. Any exceptions would only serve as precedents for carving more exceptions, and invite creative accounting mechanisms aimed at escaping royalty obligations."

One Indian commenter recommended replacing the word "entitled" with the phrase "accrued or accruing to" while another State commenter supported retaining the word "entitled" because it confirms the lessee's "obligation to act in the best interests of the lessor." This same commenter, however, pointed out: "In the Purpose and Background statement, MMS states that it is the intent of the regulations to include as royalty all of the benefits accruing, or that could accrue, to the lessee. However, the actual definition of gross proceeds does not encompass all potential benefits. For example, a lessee may accept a lower price for its production from a Federal lease for the opportunity to sell to the particular purchaser its production from other leases. Despite the difficulties of attributing a value to such an opportunity, it is a benefit accruing to the lessee under its sales contract. The language of the definition, however, suggests that 'gross proceeds' only encompasses consideration that has been stated in dollar terms. Thus, it technically does not include all of the benefits that could accrue under a sales contract."

A majority of those commenters that objected to the proposed definition expressed the same basic arguments in support of their position. Several industry commenters argued that the proposed definition contains language which is too expansive, claiming that the word "entitled" injects uncertainty and subjectivity into valuation. In addition, this term is considered objectionable by some because, as one commenter stated, "the intent of 'entitled' is not clearly understood, nor is it a clearly defined legal term. Lessees cannot know how either they or MMS auditors will, or should, apply the 'entitled' concept." They recommend deleting this term and abandoning the underlying concept altogether.

A few industry commenters suggested that the proposed definition does not conform to the terms of Federal and Indian oil and gas leases nor the statutes under which they were issued. They argue that the present definition "attempts to collect royalty on consideration received by the lessee [for] other than production saved, removed, or sold from the lease" and that it seeks to redefine "value" to include income or credits which are unrelated to such production.

Other industry commenters agreed with this overall approach, especially as it relates to reimbursements for "production costs" and "post-production costs." One commenter addressed this point at length: "This definition must be changed to limit the royalty to the value of the production at the lease. The current expansive definition allows MMS to reach far beyond that value to confiscate the value added by post-production activities. The MMS has misread the *The California Co. v. Udall* decision to require the lessee to do much more than place production in a marketable condition. If production could be sold at a lease but the lessee determines to enhance the value by retaining control and further processing it, the value added or reimbursements for the costs of such further handling are not appropriate for consideration in the value of the product for royalty purposes."

Many of the industry commenters objected to the "laundry list" of services they asserted are unrelated to production being included as part of "gross proceeds." One industry commenter urged MMS to adopt language which would specifically allow a variety of costs to be deducted from gross proceeds in order to arrive at the value of production.

A few industry commenters concluded that the definition, in its present form, is inconsistent with industry practice and not responsive to the "interaction of market forces."

One industry commenter noted that "some of the items specifically identified as subject to royalty under the gross proceeds concept are the subject of ongoing litigation and the MMS should not preempt judicial decision through regulation."

One State commenter asserted that the definition is only necessary as a determinant of minimum value and, in this sense, should be as expansive as possible. This commenter suggested that "the words 'but is not limited to' need to be added after the words 'gross proceeds, as applied to oil also includes.' " This language was thought to be needed because there is "no reason to restrict the term gross proceeds to encompass only those items listed." Furthermore, this commenter is concerned that the present language will "restrict the Secretary's authority to react if different types of sales arrangements arise in the future."

Another industry commenter asserted that there are "serious ambiguities and inconsistencies" in the definition of gross proceeds "as related to transportation deductions imposed by oil purchasers. These ambiguities and inconsistencies could be interpreted to preclude the use of a market-based value for royalty oil where oil purchasers in the area deduct actual transportation costs from their posted prices."

A large number of industry commenters recommended that MMS adopt the definition proposed by the RMAC Oil Valuation Panel which reads as follows: "*Gross proceeds (for royalty payment purposes)* means the consideration accrued to the lessee for production removed or sold from a Federal, Tribal, or Indian allotted lease."

Many of the comments on the second draft final rule addressed the gross proceeds definition, particularly industry comments. These comments again generally stated that the definition is too expansive.

MMS Response: In the draft final rule, MMS included a definition which was modified slightly from the original proposal. In the second draft final rule, MMS again made a 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. MMS cannot adopt that standard and then not require lessees to pay royalties in accordance with the express terms of those contracts. (See § 206.102(j).) It is MMS's intent that the definition be expansive to include all consideration flowing from the buyer to the seller for the oil, 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-length contract.

Therefore, MMS purposefully has 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 consideration 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.

The so-called "laundry list" of services are all benefits that a lessee may be legally entitled to under the terms of the contract and are considered part of the value for the production from the lease. Costs of production and placing production in marketable condition are considered services that the lessee is obligated to perform at no cost to the Federal Government or Indian lessor.

"Indian Tribe"—MMS has corrected the typographical error in the proposed definition and has replaced the word "state" with the words "United States."

"Lease"—One Indian commenter focused on the following issue: "Inclusion of any contract, profit-sharing arrangement, joint venture, or other agreement in the term 'lease' as opposed to a more standardized Bureau of Indian Affairs (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: Contracts, profit-sharing arrangements, and joint ventures are all examples of types of valid leases already in existence. All specify royalty provisions, some more detailed than others. Nonetheless, they all qualify under the definition of "lease." Therefore, MMS has retained the proposed definition in the final rule.

"Lessee"—The proposed definition of "lessee" generated comments from the industry and from States. By far the most significant issue raised is that the proposed definition is inconsistent with the statutory definition of "lessee" found in the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA). The originally proposed definition uses the phrase "or any person who has *assumed* an obligation" whereas the language in FOGRMA uses the word "*assigned*" in place of the word "assumed." The commenters argued that MMS's use of the word "assumed" expands the definition beyond the intent of Congress and "seeks to invalidate the lease provisions with respect to royalty payment * * *" They further asserted that there is no reason to redefine the term and recommended using the definition found in FOGRMA at section 3(7), 30 U.S.C. 1702(7).

Two industry commenters suggested that the definition be narrowed to "exclude persons who have assumed an obligation to make royalty and other payments required by the lease." Their argument focused on the difference in responsibilities between lessees and payors: "The payor is not necessarily a lessee and should not be defined as one. A lessee is bound by the terms of a lease agreement while a payor is not."

Two industry commenters suggested that the definition as provided in FOGRMA should be revised for the purposes of these regulations for the sake of clarity.

A State commenter objected to the proposed definition because it has the effect of spreading "the reporting and payment responsibility among numerous parties. With each of these parties reporting and paying separately, no single party has the responsibility to insure that 100 percent of all production is reported and 100 percent of the royalties are paid."

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." 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 payor does not properly pay the royalties due the lessor.

"Like-quality lease products"—Several Indian commenters stated that the definition should not include any reference to legal characteristics. The concern of many of these commenters was that this criterion could result in State-imposed limitations on royalty values.

MMS Response: The MMS disagrees that reference to legal characteristics should be deleted. The term like-quality is used in the rules for comparability purposes. If oil is regulated, only oil in the same regulated category should be considered in a comparability analysis.

"Load Oil"—One industry commenter suggested that the word "fuel" be added as noted in the following proposed language: "*Load oil* means any oil which has been used with respect to the operation of oil or gas wells for *fuel*, stimulation, workover, chemical treatment, production or such other purposes as the operator may elect."

A State commenter recommended deleting the phrase "as the operator may elect" from the definition because: "There is no reason to institutionalize, in an enforceable regulatory form, a standard of lessee discretion."

MMS Response: Load oil is distinguished by MMS as oil used for the purposes of stimulating production through injection into the wellbore. Using oil for the purposes of enhancing the value of, or otherwise treating, lease production at the surface is not considered "load oil." Thus, oil used as fuel is not load oil. Also, in order to eliminate confusion, MMS has deleted the phrase "or such other purposes as the operator may elect."

"Marketable condition"—Only a few persons commented on this definition. A State commenter addressed the following concerns: "The definition states that product will be deemed marketable if it is 'in a condition that will be accepted by a purchaser under a sales contract typical for the field or area.' Such contracts, now or in the future, may provide that the purchaser bear the costs of the treatment necessary to place products in a marketable condition. Under the definition, as written, therefore, there would be a theoretical market for untreated product, and MMS would lose the benefit of the increased value attributable to requiring the lessee to perform the necessary conditioning.

"An additional problem exists because of the difficulty of determining what is 'typical' for the field or area. This is because of the same informational difficulties that disable MMS from adequately applying the majority portion analysis. Without full access to the range of sales arrangements that may exist for production in a given area, MMS will be forced to rely on lessee-selected documentation in order to determine what type of conditioning is 'typical' for the area."

Two industry commenters stated that the definition is too subjective and provides no guidance to the lessee.

MMS Response: The MMS believes it is highly unlikely that the oil industry would change the quality requirements for oil sales to avoid paying royalties on nonrecoverable marketing costs. If such an arrangement occurred, MMS would then need to determine if the arrangement is an attempt to avoid paying royalties on the market value of the oil, or a contract to not only purchase the oil, but to place it in

marketable condition as well. In either case, the costs for placing the product in marketable condition would not be an allowable deduction from the value for royalty purposes. (See § 206.102(i).)

"Marketing Affiliate"—MMS received several comments that sales to marketing affiliates who then resell the oil to third persons should not be treated under the rules as non-arm's-length sales. 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 oil 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 oil from other sources, then that affiliate's posted price or oil sales contract prices could be used in determining value if they satisfy the first benchmark. Also, deleting the term "only" from the definition may require the lessee to track production much farther downstream than the point at which it can be valued under the benchmarks.

"Net-back method"—Two State commenters objected to the proposed definition and industry commenters recommended adding clarifying language. The following discussion outlines the position of the two State commenters that found the proposed definition objectionable: "Briefly, our objections are twofold: 1. Net-back is a useful method to independently cross-check lessee declared values, and thus its use should not be restricted to those situations in which the 'first' sale, transfer, or use is downstream from the lease.

"Second, net-back should be allowed from any reasonable point at which a value can be ascribed to the product. There is no guarantee that the 'initial sales point' or 'first alternate point' will exhibit the open market conditions essential for attribution of a true value for the products.

"We therefore propose the following alternate definition: Net-back method means a procedure for valuing or verifying prices assigned to lease products or for independent cross checking of the validity of the gross proceeds of lease products or of prices posted or paid in a field or area. The procedure involves calculating back from any downstream point at which values for such products reasonably and fairly can be derived. In applying the net-back, consideration will be given to the reasonable costs of processing and transportation from the producing lease, unit or communitized area to arrive at a value for the products at the lease."

The industry commenter recommended that the following language be added to the proposed definition: "In net back calculation the alternate point used for value determination shall be the point which is the closest point to the lease at which a price for similar lease products can be established by alternate means. Such alternate means may include posted prices or published spot market prices."

MMS Response: Upon review, MMS determined that the originally proposed definition of net-back was too broad—it applied to any situation where lease production is sold at a point off the lease. 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 oil production from a Federal lease is used-on lease to generate electricity which is then sold. If the value of the oil cannot be determined through application of the first four benchmarks in the regulations (see § 206.102(c)), then a net-back method would involve beginning with the sale price of the electricity and then 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 oil production and "Stainmaster Carpet," if the value of the second product can be determined through comparison with sales of other such products in the same market, MMS would begin the net-back from that product, not from the sale price of the carpet.

"Person"—One Indian commenter supported the inclusion of "joint venture" in the definition of "person" while two industry commenters recommended that "joint venture" be deleted. The rationale these two commenters rely on as the basis for recommending deletion is that the term "person" is used in the definition of "arm's-length contract" and if "that definition is not altered as suggested herein, then inclusion of a joint venture in the definition of person will further narrow the definition of arm's-length transaction by clouding the issue of control and the application of the definition [of] arm's-length to other joint venturer transactions." Another industry commenter advocated replacing the word "firm" with the word "company" because they believe that, in this context, it would be more appropriate. 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"—The proposed definition received only a few comments, two of which recommended expanding the definition of posted price to include the phrase "or at the specific onshore or offshore terminal(s) listed in the announcement" after the words "in the field." These industry commenters stated that there are "currently very few 'field postings,' rather there are terminal postings" and that expansion of the definition as noted above would avoid confusion in applying the definition.

Another industry commenter believed that the word "posted" is outdated and that some purchasers may not publish a price bulletin, instead providing price quotations or notices to any seller desiring to do business with the purchaser.

A State commenter recommended deleting the phrase "net of all deductions" for the following reasons: "The 'net of all deductions' language should be deleted. MMS has proposed a system of allowances, which as a practical matter makes the 'net of deduction' language unnecessary for the purposes of defining 'posted price.' This proposal could be interpreted to institutionalize the allowances without a mechanism of independent cross-check by MMS.

"Common industry deductions are for transportation and conditioning. Yet there are no restrictions upon what a poster can include as a deduction from the posted price. Thus MMS must retain

the power to scrutinize such matters, and add such deductions back into the value of the production when necessary."

This same commenter believed that the definition is too restrictive: "We also object to restricting the definition of posted price to formal price bulletins. Rather, the definition should be broader and include both prices posted and those regularly paid. It is not unusual for a buyer to come into the market and offer publicly a price for crude, which is like a posting but not necessarily a price bulletin. Such publicly announced offers to buy could be at a price higher than offered in a price bulletin, and are no less 'market determined' than supposedly are postings in bulletins. Price bulletins are, generally, only circulated by the major companies and thus reliance on them may give undue advantage to the ability of those companies to establish prices." A State commenter also recommended deleting the phrase "and location for oil in marketable condition" stating that this provision authorizes lessees to, in effect, deduct transportation costs without any review by MMS.

MMS Response: The MMS is expanding the definition in the final rule to include references to onshore and offshore "terminal postings" and "price notices." For clarification purposes, the word "condition" replaces the word "quality" which follows the word "marketable" in the first sentence. The phrase "net of all adjustments" has been revised to read "net of all adjustments to." As used in this definition, the term "adjustments" refers to deductions from the price of oil for quality adjustments such as API gravity and sulfur content. Adjustments for location also may be taken into account where appropriate. It would be unfair not to take into account price reductions which reflect location.

"Processing"—MMS has added a definition of "processing" as any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression are not considered processing. Under this definition, the changing of pressures and/or temperatures in a reservoir is not considered processing.

Section 206.102 Valuation standards.

Section 206.102(a) sets the basic standard that the value for royalty purposes will be the value of the oil determined pursuant to this section less applicable allowances. One State commenter recommended that the phrase "less applicable transportation allowances" be deleted because it is unnecessary, confusing, and because it implies that the lessee can deduct the transportation allowance from the value received and report the resultant reduced value as a single line item.

MMS Response: The regulation as adopted refers to "applicable" allowances, which includes transportation allowances. It does not imply that any and all costs can be deducted. Also, it refers to "this Subpart" which includes § 206.105. That section provides complete details regarding transportation allowances. Therefore, this suggestion was not adopted.

Two Indian commenters recommended that the paragraph be modified by (1) deleting any reference to the transportation allowances because they are improper for Indian leases, and (2) adding the phrase "in marketable condition."

MMS Response: Transportation allowances are allowable under most Indian leases. It has been MMS's practice to grant such allowances. If an Indian lease restricts such allowances, then the lease terms will govern.

The MMS does not agree that the phrase "in marketable condition" should be inserted prior to the word "determined." Section 206.102(i) requires that oil be placed in marketable condition at no cost to the lessor. Thus, because § 206.102(a) provides that value be "determined pursuant to this section," the marketability requirement already is included.

The MMS is including in the final rule a new paragraph (a)(2) which states that 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, 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 value for royalty purposes will be based upon the higher of those two values. The draft final rule included a provision that, if MMS determined that the major portion results in an unreasonably high value, then it would 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 instances will be reasonable because at least half the oil is sold at or above that price. 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)(2) a description of how the major portion is computed. It will be determined using like-quality oil sold under arm's-length contracts 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 barrel of the oil (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.

One industry commenter was critical of the major portion analysis claiming that it could yield erratic results in some circumstances. An Indian commenter suggested that MMS use the Conservation Division Manual procedure for computing major portion which was claimed to be different from what was included in the rules.

MMS Response: The major portion analysis has been a part of valuation procedures for at least 45 years. The MMS considers it to be a workable procedure. The MMS maintains that the procedure contained in the final rules is consistent with the Conservation Division Manual (which no longer is in effect).

Section 206.102(b) provides the valuation procedure for valuing oil sold pursuant to arm's-length contracts. Many comments were received regarding the concept of valuing oil on the basis of gross proceeds received under an arm's-length contract. They were about equally divided in number as to those in favor and those opposed.

Several State and Indian commenters, and one State/Indian association disagreed with the concept of valuing oil on the basis of gross proceeds received

under an arm's-length contract. The commenters contend that, historically, gross proceeds has been regarded as a minimum value and that it has long been recognized that a market value clause in a lease "is distinctly and substantially different from a gross proceeds clause." They were concerned that the concept establishes an industry honor system. Also, concern was expressed that the proposed regulations be consistent with the provisions of the Indian lease agreement, and they questioned whether the proposed regulation permits the Secretary to discharge his/her responsibilities to the Indian lessors. Those commenters maintained that whether an arm's-length transaction yields market value depends upon the definition of arm's-length contract.

Two State and two Indian commenters expressed concern that the proposed regulations will institutionalize an industry "honor system" for valuation of Federal royalty production. The commenters stated that the rules provide no mechanism for independent oversight and cross-check of lessee declarations of value and impose such impossible information burdens on government that they can only result in total reliance on lessee-generated information. They stated further that whether an arm's-length transaction yields market value depends upon the definition of "arm's-length" and whether independent price checks confirm the receipt of proceeds.

The commenters pointed out that many sales arrangements may appear to be arm's-length on the surface, but in actuality the producers are "captive shippers" subject to forced sale and the purchaser's take-it-or-leave-it price. This scenario is stated to be contrary to the common legal understanding of an arm's-length market-determined price. The commenters noted that MMS's definition of "arm's-length" does not even contain the minimum acceptable requirements, in a legal sense, necessary to assure that such contracts are, in fact, arm's-length. They argue that the use of an arm's-length/gross proceeds valuation method requires that such matters as open-market conditions and the relationships between parties, beyond mere affiliation, be investigated. Also, the commenters stated that MMS does not confin arm's-length to those contracts that involve only the consideration for the sale of lease products. Coupled with the proposed definition of gross proceeds, the commenters believe "this allows lessees the opportunity to manipulate the prices received for their production from a Federal lease by accepting a lower price in order to sell production from other non-Federal leases, possibly at a more profitable price."

MMS Response: In response to a large number of comments from the States, Indians, and industry, MMS has modified the regulations which govern the valuation of oil 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. 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 oil 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 equitable value on which to base royalties. Under the final regulations, in most instances the lessee will not need 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.

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 effort. 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.

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. As an example, in return for Seller's reduced price for oil production from a Federal lease, Buyer may agree to reduce the price of gas it sells to the Seller from a non-Federal lease. This agreement is not reflected in the oil 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 oil production be valued in accordance with paragraph (c), the standards used to value oil 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 several industry comments suggesting that this section be deleted, MMS is retaining it in the final rules.

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. 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 once 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 negligence in negotiating a 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 oil production be valued pursuant to the first applicable of paragraphs (c)(2), (c)(3), (c)(4), or (c)(5). 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 the 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 lessee 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 fraudently manipulated, or negligence in negotiating contracts.

The MMS believes that new § 206.102(b)(1) establishes a more definable standard than paragraph (b)(1) of the draft final rule at 52 FR 30657 ("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)(1)(iii). Generally, 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 opportunity to comment. MMS has put such a provision in the rules.

If valuation in accordance with the fourth and fifth benchmarks in paragraph (c) is required, then the lessee also must follow the notification requirements of paragraph (e)(2).

One Indian commenter suggested that the lessee should certify that this is the highest price he could have received for that oil at the time of the sale. The same commenter also noted that MMS's regulations, at a minimum, must be consistent with the language of the Indian leases. Other Indian commenters stated that the concept of basing royalty on gross proceeds received under an arm's-length contract is not in accord with the responsibilities of the Secretary. One of these commenters stated that "the lease and regulations provide that value be determined, not gross proceeds. Gross proceeds is merely evidence of such value. Acceptance of gross proceeds as conclusive evidence of value is an abrogation of the Secretary's fiduciary duties, especially if the previous MMS practice of accepting reports from lessees without scrutiny continues."

MMS Response: The MMS believes that the regulations as adopted, with the changes discussed earlier, will permit the Secretary to discharge his/her responsibilities properly.

One State commenter objected to the whole approach of the regulations. It was suggested that auditors need to be given additional flexibility to disregard deflated prices. This commenter believed that "gross proceeds" should be set aside as a valuation method where "outside consideration" may have caused contract prices to be reduced.

MMS Response: The MMS has concluded that the final rules strike a reasonable balance between allowing MMS not to accept arm's-length contract prices in appropriate circumstances and giving the lessee some certainty that its arm's-length prices will be acceptable as value. No additional changes were made.

One State commenter objected to the phrase "monitoring, review, and audit" or similar phrases which appear throughout the proposed regulations because it suggests that the terms listed are synonymous. An MMS review or reconciliation is not the same as a full audit. The commenter suggested that the following paragraph be added:

"( ) 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 as against the Federal Government, its beneficiaries, the Indian Tribes or allottees until after full audit."

Also, the commenter suggested that the words "lease terms, or relevant statutes" need to be added after the words "requirements of these regulations" in proposed § 206.102(b) and (d)(1), for purposes of clarification and precision.

MMS Response: The suggested additional paragraph language has been included in the final rule as § 206.102(k) with minor modifications. This paragraph reflects MMS's longstanding view that a value determination based on limited review does not estop the MMS from redetermining that value until an audit has been completed and the audit period formally closed. MMS intends, however, to prepare more detailed guidelines as to when an audit is closed. The phrase "lease terms, or relevant statutes" has not been added to § 206.102(b) because there is a provision in the regulations that in the event of conflict the lease terms govern. Likewise, all persons are subject to statutory requirements.

Two suggestions were made regarding the establishment of a floor value. One Indian commenter objected to the proposed regulations because they "* * * would permit MMS to rely upon an industry honor system for valuation of Federal royalty production." However, if MMS's proposed valuation approach is to be adopted, they suggested that § 206.102(b) be revised to read as follows:

"The value of oil 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 oil in the same field or area. If such proceeds do fall more than 10 percent of such prices, the value of oil in that case shall be 10 percent below the greater of the highest price paid or posted for similar oil in the same field or area." It was stated that this approach will permit MMS to have a uniform and administratively simple benchmark to establish market value, rather than "evaluating each contract on a case-by-case basis in light of the many possible indicia of a sale at less than fair market value * * *."

Another Indian commenter stated that: "The proposed regulations would allow substantial manipulation and undervaluation of the royalty amount. Most centrally, it is unacceptable to allow lessees to use contract prices as the royalty value without adequate safeguards to assure a fair valuation for the public's resources. At a minimum, only prices under *genuine* arm's-length contracts should be acceptable for royalty purposes. The proposed regulations would allow collusive contracts to qualify as 'arm's-length contracts.'" It was also stated that if MMS remains intent upon accepting royalty on the basis of what the commenter considers to be below-value contract prices, "we urge that MMS at least impose a floor value, such as 80 percent of the value of production as determined under the 'value' criteria applicable to oil not sold under arm's-length contracts."

MMS Response: The MMS generally does not believe that establishment of a "floor value" (other than gross proceeds) is appropriate or equitable because it could result in royalty being assessed on a value greater than the lessee received under an acceptable arm's-length contract. Where an arm's-length contract operates to set the price at

which the lessee can sell the production, that contract likewise should set the royalty value in most circumstances. However, under the lease and the regulations, MMS has the authority to establish value for royalty purposes and will do so for non-arm's-length contracts where it is justified, even if such value is higher than the gross proceeds received by the lessee. Also, as explained above, for many Indian leases, because of the specific lease terms, MMS will compare values determined using arm's-length contract prices with the highest price paid for a major portion of production and generally use the higher of the two.

One Indian commenter raised the question of what "which could accrue" means and also pointed out that, if the value of oil is to be based on gross proceeds, the regulations need to be more precise in stating which gross proceeds are to be used.

MMS Response: The regulations include a detailed definition of the term "gross proceeds." The MMS believes the definition is adequate. MMS has deleted the phrase "or which could accrue" from the final rule.

Many commenters approved of the concept of valuing oil on the basis of gross proceeds received under an arm's-length contract. Basic reasons for approval were stated in one comment as follows: "This standard is fair and reasonable; it will promote necessary certainty and consistency for the lessor and lessee alike; it is based on the lease language; it is administratively feasible; and it relies on an objective valuation mechanism—the market. It is appropriate in arm's-length situations because both the buyer and the seller have agreed to be bound by the best price each thought it could get for the duration of the contract. In such circumstances the royalty owner's interest in securing fair market value is protected by the arm's-length nature of the transaction." The 11 industry commenters also objected to use of the phrase "or which could accrue" in the first sentence. This objection can best be summarized in the following comment: "Use of the phrase creates uncertainty and subjectivity and should not be implemented in regulations which must have certainty as a foundation." Industry commenters stated that it is unfair for the lessor to determine after the fact that proceeds "could be accrued." Also, one of these commenters noted that lessees act in a competitive market and "in the absence of fraud, cannot fairly be held to a *post hoc* determination that proceeds could have accrued." One of these commenters summarized as follows: "In sum, the proposed definition of 'gross proceeds' is in need of substantial revision. The MMS should modify it to include only those monies actually received for the sale of production. Other regulations which would require payment of royalties on phantom proceeds should also be amended accordingly."

MMS Response: The MMS believes that gross proceeds under an arm's-length contract generally constitutes the market value of a commodity. This does not preclude MMS from establishing a value where necessary; e.g., the contract does not meet MMS's standards for an arm's-length contract, the lease agreement requires a different value, or the lessee has engaged in misconduct. The phrase, "or which could accrue," is deleted from the final rule. As noted above, many commenters thought that this phrase would allow MMS to second-guess the price which the lessee agreed to in its arm's-length contract by arguing that other persons selling oil 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 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.

Many comments were received regarding the proposed benchmark system in § 206.102(c). They were about equally divided in number as to those in favor and those opposed.

Several States, Indians, and one State/Indian association objected to the proposed benchmark system. Most of these commenters supported highest posted prices using the net-back procedure as verification. One of their objections to the benchmark system is that the proposed methodologies are unworkable and provide no reasonable method of verification. Another objection is that the proposed system would impair effective oversight and reduce royalties. Also, these objectors state that in their view the proposed procedures would severely burden the audit program and, as a practical matter, would preclude adequate verification of the "lessee's declarations." In addition, they stated that the use of the net-back procedure is unduly restricted, and, to the contrary, should be used frequently for independent verification. They believe that more readily verifiable methods should be used to ensure that fair-market value is being received.

One of these commenters summarized a number of objections as follows: "Historically, gross proceeds has been regarded as minimum value; however, the proposed benchmarks appear to be primarily aimed at converting gross proceeds as *the* value. Gross proceeds is not necessarily fair market value. Published gross proceeds are not always all consideration received, for example, drilling advances and special equipment lease agreements." Also, "* * * no mechanisms are provided to cross-check * * * values reported under the first three benchmarks; since MMS has taken the notion that it does not have the authority to obtain access to other arm's-length contracts from producers not obligated to report to MMS, comparisons could not be made." It was also stated that "The most effective benchmark, net back calculation, would never be used because of the prioritized order of other valuation methods."

Some commenters stated that the benchmarks should not be prioritized. Rather, value should be determined by using the most applicable benchmark. These same commenters recommended modifying the first benchmark to require comparison with other posted prices or contract prices in the field.

MMS Response: The MMS believes that a prioritized benchmark system is workable and fair. Obviously, for OCS leases, MMS has access to information regarding all posted prices and contracts (if any). In addition, the majority of onshore fields with Federal lands are comprised of a significant percentage of such lands (if not the majority) so that needed price information is readily available. In many instances, Indian lands comprise a significant portion of an oil field. Where necessary, information sometimes can be obtained from the appropriate State agency. Although price and field boundary data are available for most onshore leases, the acquisition of volume data associated with an arm's-length sale has been difficult to obtain. Accordingly, MMS has added § 206.102(d) which provides that any Federal or Indian lessee will make available upon request to the authorized MMS, State and Indian representatives, and others, arm's-length sales and volume data for like-quality production in the field or area or nearby fields or areas. Undoubtedly, there will

be a few instances where it will be difficult to obtain needed information, but this is true of any procedure adopted.

The MMS believes that, in the vast majority of cases, gross proceeds constitute market value. In those cases where this is not true, MMS will establish an appropriate value for royalty purposes. "Arm's-length" sales will not be accepted without question. The MMS will obtain needed information to ascertain that they are truly arm's-length as defined in the regulations.

In response to comments that the first benchmark should not accept a lessee's posted prices without some comparison of other postings in the field, MMS has modified the first benchmark. Under this benchmark, the value still will be the lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area). However, the lessee also must demonstrate that those prices are comparable to other contemporaneous posted prices or oil sales contract prices for purchases or sales of significant quantities of like-quality oil in the same field (or area). To evaluate comparability, the factors include price, duration, market or markets served, terms, quality of oil, volume, and such other factors as may be appropriate to reflect the value of the oil.

MMS received many industry comments suggesting that the first benchmark exclude the requirement that the lessee's own posted price or oil sales contract prices be comparable to posted prices or oil sales contract prices of others. Because sales data of other persons often is not available, the commenters believe that uncertainty has unnecessarily been introduced into the process. One industry commenter believed that the benchmark, as revised, would be workable and provide sufficient flexibility.

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

One Indian commenter criticized the benchmark system as follows: "The utter failure of MMS to recognize its obligation to maximize tribal royalties is evidenced also in the provisions governing valuations where arm'slength contracts do not exist. Each of the three alternative methods require a determination that the lessee's sales price is similar to that for purchases of significant quantities of like oil in the same field or area. The 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 contemporary posted prices. Posted prices in the oil industry, however, are generated by the purchasers and not the sellers. Either MMS had made an error in its drafting or this benchmark plainly is so ridden with potential conflicts of interest that it can not possibly be urged as consistent with the Federal fiduciary duty to maximize Indian oil and gas resource returns."

Another Indian commenter suggested that the desired goal of certainty can be accomplished by use of the highest price paid method: "MMS' embracement of the contract price approach in its drive towards certainty in value can be as easily achieved through the highest price paid method. It would also encourage producers when negotiating contracts to come as close to that figure as possible knowing that is what they will have to pay the royalty on. The contract sales approach proposed by MMS does not encourage obtaining the maximum value for the resource by the purchaser [lessee]."

MMS Response: In many instances the lessee, being a purchaser, has published a posted price bulletin. Posted price bulletins are generally available. In addition, the lessee must retain all data which are subject to audit. From experience, MMS does not believe that basing all royalties on the highest price in the field or area is fair or in the best interests of the Federal or Indian lessor. Therefore, such a standard was not adopted.

One State commenter noted that the modifier "contemporaneous" in three of the sections is vague and undefined. "For a purchase under a posting or contract to be used as an indicia of value for the monthly reporting period, it should relate to production during the same reporting period."

MMS Response: MMS has added § 206.102(c)(6) to the final rule which defines "contemporaneous" as postings or prices in effect at the time the royalty obligation is incurred. This means the postings or contract prices in effect at the time oil is removed, sold, or otherwise disposed of in a manner which results in royalty being due on the oil.

According to one State commenter, "It is difficult to establish an alternative system to calculate fair market value * * *. The MMS should use the posted price criteria of the benchmark system verified by a net-back analysis to assure the credibility of posted prices."

MMS Response: The MMS believes that the use of a routine net-back analysis on a routine basis to verify oil value is impractical and unnecessary.

Two Indian commenters expressed concern about the prioritized benchmark system. They argued that restricting the Secretary's ability to use different methodologies in any order the Secretary chooses will tie the Secretary's hands in dealing with difficult situations.

MMS Response: The MMS believes that the regulations adopted will permit the Secretary to discharge his/her responsibilities to the Tribes and allottees and will provide certainty in the valuation process to both the lessees and lessors. Although a prioritized benchmark system does limit flexibility, this drawback is outweighed by the benefits of certainty.

One State commenter thought there is a lack of guidance in administering the prioritized benchmark system and that MMS does not indicate what kind of evidence will be sufficient to permit an auditor to continue down the list of benchmarks.

MMS Response: The MMS will require that the lessee make a reasonable effort to apply a benchmark before proceeding to the next. Auditors must be satisfied that lessee information is sufficiently accurate and complete to implement a benchmark. The addition of § 206.102(d), whereby lessees must provide arm's-length sales and volume information, will assist in the enforcement of these "comparability" requirements. It would be impossible for MMS to attempt to implement a procedure where government has to make all the decisions. Such a procedure would impose a tremendous administrative burden which would be very costly.

Some industry and State commenters expressed concern regarding the lack of an adequate definition of the terms "significant quantities" and "field or area", and the administrative problems that will result therefrom. One State commenter stated that the term "significant quantities" is vague and undefined. An industry commenter recommended that the term "significant quantities" be deleted because (1) posted prices in an open marketplace "are for no other purpose than determining market value", and (2) the lessee has no way of knowing the quantity of volumes purchased by other purchasers in the area.

MMS Response: As was discussed in the preamble to the proposed rules (52 FR 1858, January 15, 1987), the term "significant quantities" is variable depending on the sales volumes from the field and the volume of production. What constitutes significant production from an onshore field may not be significant for an OCS field. Therefore, "significant quantities" will vary case by case.

One Indian commenter stated that "* * * many posted prices are artificially low because there is low demand, but there is still a threshold low amount where a company will purchase more than their demand" and recommended that "* * * the totality of the circumstances should be utilized (and set forth in the regulations), including spot markets, highest posted prices, and to some extent, posting for similar oil in other fields."

MMS Response: The current regulations, which are being revised in response to heavy criticism, list the various criteria with no specific priority. The purpose of the benchmark system is to provide all concerned with a reasonable degree of certainty as to criteria to be used in valuing oil.

One industry commenter stated that the prioritized benchmark system "imposes a prejudicial valuation on an affiliated lessee" because a nonaffiliate receiving the same price as an affiliate would pay on actual proceeds received, whereas the affiliate may have to pay a higher royalty under, for example, benchmark 206.102(c)(2). The recommendation was made that "* * * the first applicable of the following subsections" * * * language in § 206.102(c) be replaced with "* * * any of the applicable subsections."

MMS Response: The situation described could occur. However, MMS believes that, generally, posted prices for like-quality oil in the same field or area will be comparable. Thus, there likely will be little or no disparity in the values in most situations.

Many industry commenters, a Federal agency, and an individual approved of the proposed benchmark system. One industry commenter stated that they "* * * strongly support the adoption of clear and consistent standards of valuation for royalty oil based upon the true value of the product—the price received in the marketplace for the sale of that oil. The valuation proposal * * * recognizes the interaction of competing market forces and recognizes that a seller of oil will normally negotiate the best deal it can to further its own interests. The use of a price that is generally available to all sellers is a much more reasonable approach to the determination of 'value' for a given supply of oil than the arbitrary selection of a price that one seller may have received under circumstances that do not include all sellers. Where an arm's-length contract does not exist, the benchmark system of valuation permits an objective procedure for arriving at the valuation based upon posted prices which have been the basis for sales of oil for many years." Another industry commenter supported both the benchmarks and their prioritization because both will add certainty to valuation determinations. Also, the use of the lessee's contemporaneous posting will provide a "benchmark valuation for many major producers." One industry commenter noted that "This ordering of the benchmarks is the result of extensive public comment which showed that, for valuation of oil, posted prices should be moved closer to the top of the hierarchy insofar as posted prices account for the vast majority of oil transactions."

MMS Response: The MMS believes that the proposed benchmark system is a valid and realistic system for determining the value of oil not sold pursuant to an arm's-length contract. The benchmarks are primarily based on posted prices which are the normal basis for oil sales and which reflect the price of oil in a free and open market. Posted price information for significant quantities of like-quality oil sold from a field or area will normally be available. The addition of § 206.102(d) will permit necessary information on arm's-length sales to be obtained. In other situations, the benchmarks provide for use of spot sale prices, net-back, or any other reasonable method.

One industry commenter noted that most, if not all, posted prices are prices posted by a purchasing, marketing, or transporting entity, some of which may have producing lessee affiliates. "However, taken literally, there will not be a *lessee's* posted price."

MMS Response: MMS has added a new § 206.102(c)(6) which defines lessee, for purposes of this section, as including a designated purchasing agent.

One State commenter noted that proposed § 206.102(c)(1) fails to anticipate that a lessee could make purchases at different postings within the same reporting period and suggests that, in such a case, "the volume weighted average would seem to be appropriately specified, because it could be easily computed by the payor and would be less susceptible to manipulation by the payor."

MMS Response: The MMS concurs with this change and has included language to implement it in § 206.102(c)(1).

One Indian commenter stated that the use of this benchmark (contemporaneous posted prices) rather than the major-portion analysis provided for in existing oil and gas regulations represents a breach of the Secretary's trust obligations.

MMS Response: The MMS believes that the regulations as adopted will permit the Secretary to discharge his/her responsibilities. Major portion analysis will be used under the final regulations, where appropriate.

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

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

One industry commenter recommended that paragraph (c)(2) be modified by adding the phrase "known to the lessee" after the word "prices" so that the first part of the sentence would read, "The arithmetic average of contemporaneous posted prices, known to the lessee, used in arm's-length transactions * * *."

MMS Response: This suggestion was not adopted because it results in too great a degree of subjectivity.

One industry commenter supported the use of "arithmetic average" as a benchmark, but suggested that there should either be an agreement between the lessees and MMS as to which companies' postings are to be used, or that MMS publish a list of the companies whose postings may be used to calculate an arithmetic average. The commenter pointed out that in the case of South Louisiana (used for offshore) there are at least one dozen companies that post oil prices and there could be price changes in one month on different dates by all of the companies.

MMS Response: The MMS may decide, upon request, on the basis of an individual case, to designate postings to be used in calculating an arithmetic average. It is not considered practical to do this continuously.

Three Indian commenters objected to the use of "arithmetic average" and recommended that a "weighted average" be used instead. Another commenter stated that use of "arithmetic average will not yield a true market value because the lessee is given the opportunity to manipulate prices by selling some oil at extremely depressed prices."

MMS Response: Paragraph (c)(2) requires consideration of postings of persons other than the lessee. Although the postings are available to the lessee and to MMS, volumes often are not. Thus, requiring a weight averaging of third party data is not practical.

To make this benchmark "more workable and administratively feasible" one industry commenter recommended using the average of all postings of the relevant type of oil in an area.

MMS Response: The MMS has found that postings do not always indicate a purchaser's willingness to buy. Therefore, any average which includes all postings may become skewed because of posted prices which are not market responsive. Pursuant to § 206.102(c) (1), (2), and (3), there must be significant quantities of oil sold before a posting or contract price can be averaged in.

One industry commenter recommended that paragraph (c)(3) be modified by adding the phrase "known to the lessee" after the word "contracts", and by replacing the phrase "area or nearby areas" with the phrase "field or area" for reasons of "clarification."

MMS Response: The addition of the phrase "known to the lessee" was not adopted because it would result in inserting too great a degree of subjectivity. The term "field or area" was not adopted because the intent is to utilize a larger area than "field or area" in reviewing arm's-length contract prices.

One industry commenter suggested that MMS should publish a list of postings to be used to compute the arithmetic average required by subsections (2) and (3). It was thought that the large number of postings creates a monitoring and auditing/validation burden.

MMS Response: MMS recognizes that in some cases there may be several postings which will be required to be averaged. However, the information is available and it is not that burdensome for lessees. In fact, MMS expects that in certain fields lessees will be able to work together to compute averages which may be applicable to all of them.

One State commenter stated that "Subparts (iii) and (iv) attempt to distinguish between arm's-length contracts and spot sales. But, there is no basis for saying arm's-length spot sales are not also arm's-length contracts under the definitions. Additionally, there is no requirement (and there should be) that only spot sales which are genuinely arm's-length should qualify as indicia of royalty value."

MMS Response: The MMS concurs that the spot sales used in the benchmark should be arm's-length spot sales and will insert the term "arm's-length" immediately preceding "spot sales" in the final rule, § 206.102(c)(4). With regard to the first comment, if a spot sale is for a significant quantity of oil, it could be considered under paragraph (c)(3).

Some States and Indians 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. MMS agrees that the size of the sample cannot be predetermined but must depend upon the terms of the applicable benchmark and the actual circumstances in the field or area.

Most of the State and Indian commenters who opposed the benchmark system supported highest posted price with the use of a net-back method for verification of values used. One of the State commenters, in describing MMS's proposed use of net-back in proposed § 206.102(c)(5) as too restrictive, made the following statements: "* * * the government would carry the burden of establishing that none of the preceding benchmarks can be applied before it would [be] authorized to use net-back * * * In effect, net-back will rarely, if ever, be used. At the same time it is the only method of valuation proposed by MMS that can be applied independently from lessee submitted documentation."

MMS Response: The MMS agrees that there will be infrequent use of the net-back method. It is believed, however, that the other benchmarks which have higher priority will result in a reasonable value for royalty purposes and obviate the need to undertake a labor-intensive net-back method. The MMS routinely will verify lessee-generated information used in applying the benchmarks during its monitoring process and through audit.

One State commenter articulated the viewpoint of a large number of other commenters by recommending an alternative method of valuation, namely use of the highest posted price paid or offered in the field or area with the net-back procedure used as verification or backup.

The commenter also stated that "* * * the approach we suggest—highest posted or a refined product value net-back—serves the twin goals of assuring the collection of fair market value and providing certainty to the lessee. Highest [price] posted or paid is more easily determined than the arm's-length nature of a contract, and a refined product value can be calculated by the lessee itself or provided by the government. It also is an approach that is independent of lessee generated information and thus meets Congress' intent that independent methods of verification be employed. Gross proceeds would continue as the absolute minimum acceptable value."

MMS Response: The MMS believes that gross proceeds received under arm's-length contracts and posted prices used to purchase significant quantities of oil in arm's-length transactions generally represent the market value of oil and does not agree that it is necessary to perform a refined product net-back analysis to verify them.

One industry commenter expressed approval of the concept in proposed paragraph (e)(1) that prior MMS approval generally need not be obtained where value is determined pursuant to paragraph (c). One Indian commenter expressed concern that "once approval is granted, follow-up audits are unlikely", and recommended that "There should be provisions mandating routine MMS audits of valuation methods occurring at intervals not greater than one year." One industry commenter objected to the fact that MMS will not be giving prior approval stating that this subsection places "the burden * * * on the producer to prove the determination of value." One State commenter stated that the regulation should specify that the lessee retain "all data relevant to determination of royalty value," instead of "all available data to support its determination of value." That State commenter stated that the regulation should specify that MMS "will" order compliance when incorrect payments are discovered, rather than stating "MMS may direct a lessee to use a different value."

MMS Response: Although MMS will be making periodic audits, it is not appropriate to specify the scheduling, type, and timing of audits in these regulations. With regard to the second comment, the lessee is responsible to comply fully with the regulations by properly valuing the oil, for royalty purposes, in accord with the appropriate benchmark and to retain all relevant data. The MMS has adopted the suggestion that the phrase "all data relevant to determination of royalty value" be substituted for "all available data to support its determination of value" in § 206.102(e)(1). Also, the word "will" has been substituted for the word "may" in the last sentence.

Many industry commenters stated that the requirements of § 206.102 (d) and (e) to make all data available to

MMS are too broad and should be limited to fee lands within the boundaries of approved Federal units or communitized areas. They argued that lessees should not be required to provide information on their other sales prices or volumes.

MMS Response: 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.

Section 206.102(f) was proposed as § 206.102(e) and provides that lessees will pay additional royalties and interest if the lessees improperly determine value. One industry commenter recommended that any "retroactive valuation determinations" on the part of MMS "be limited to fraudulent and noncompliance situations." That commenter went on to suggest that if MMS determines that a lessee underpaid royalties, then the interest associated with those royalties should only accrue from the date of that determination until royalties are paid.

MMS Response: The lessee is responsible for properly determining value for royalty purposes in accordance with the lease terms, regulations, and appropriate instructions and court decisions. Accordingly, if royalty is underpaid, the lessee is responsible for the additional royalty due plus any interest from the time such payment(s) should have been made. MMS has adopted this section as it was proposed.

Another industry commenter agreed that underpayment of royalties was subject to interest, but recommended that MMS likewise should pay the lessee/payor any interest "statutorily authorized" on reimbursed credits or royalty offsets when royalty overpayments are discovered.

MMS Response: The 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 206.102(g) was proposed as § 206.102(f) and prescribes a procedure for a lessee to request a value determination from MMS. Some industry commenters suggested that there be a time limit of 120 days for MMS valuation responses. Some of these commenters also recommended that there be no penalties or accrual of interest for any underpayment of royalties during this period (which would not be known until after MMS's decision).

MMS Response: The MMS will make every effort to respond timely, but this is necessarily dependent upon available resources. MMS cannot agree to a regulatory time limit. Because the lessee is responsible for proper valuation, interest is assessed if the lessee makes an improper valuation. The MMS believes a lessee should be able to request a valuation determination at any time. One of the changes to this section clarifies that, when MMS makes a value determination, it may use any of the valuation criteria authorized by the rules. This gives MMS the necessary flexibility to deal with unusual situations which otherwise do not fit the regulations.

One commenter suggested that there should be opportunity for review of a value determination by the affected royalty recipient (State, Tribe, etc.) before a final decision is made because, without such review, the cooperative audit role is rendered meaningless.

MMS Response: The MMS does not consider it practical to require a review by a State or an Indian lessor when a value determination is made. The MMS will attempt to coordinate its value determinations with States doing audits under section 205 of FOGRMA and Indian Tribes doing audits under section 202 of FOGRMA. This does not make the cooperative audit role, in accordance with FOGRMA, less meaningful or effective.

One industry commenter recommended that the provision be clarified that an MMS rejection of a proposed valuation determination is appealable to either the Director or Interior Board of Land Appeals (IBLA).

MMS Response: This modification is not necessary because all MMS final orders or decisions arising from the regulations in Titles 25, 30, and 43 are appealable pursuant to 30 CFR Parts 243 and 290.

One Indian commenter recommended that lessors also should be able to request MMS determinations. They also recommended that the regulations should require MMS to notify Tribes/allottees of any changes in valuation determinations.

MMS Response: The regulations as adopted in § 206.102(g) do not provide a specific procedure for the Indian lessor to request a valuation determination from MMS. However, MMS always is available to discuss with Indian lessors any valuation issue regarding their leases.

One State commenter recommended that the third sentence be modified by adding the word "all" before "available data", and replacing "to support its proposal" with "relevant to the valuation of its production". Also, the phrase "subject to audit" should be added.

MMS Response: The MMS has made some of these changes for purposes of clarity and comprehensiveness.

Section 206.102(h) was proposed as § 206.102(g). It provides that the value for royalty purposes cannot be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances. Several industry respondents considered the phrase "or which could accrue" objectionable and urged its deletion. The main reason given for their position is that the language creates uncertainty and subjectivity, contrary to MMS's stated objective of gaining certainty and precision in royalty accounting.

MMS Response: MMS has deleted the phrase "which could accrue" from the final rule. As explained above, with respect to § 206.102(b), MMS is satisfied that the term "accruing" includes all consideration to which the lessee is entitled pursuant to its contract, not just what it actually receives.

Industry commenters suggested that some off-lease post production costs (such as those carried out on leases in "especially hostile or remote environments") and certain onlease post-production costs (such as those deemed to be "extraordinary" for onshore leases, the cost of submerged gathering lines, the cost of environmental compliance, and the cost of post-production facilities installed on leases in water depths greater than 400 feet for offshore leases) should be shared by the lessor and counted as deductions from royalty payments along with transportation allowances. One stated rationale for this suggestion is that some "post-production" costs enhance the value of the oil and, therefore, the costs should be shared by both lessee and lessor, as are the benefits. One commenter simply stated that the phrase "and other deductions" should be added to the "less applicable transportation allowances" language.

MMS Response: The MMS has modified § 206.102(h) to refer to deductions for any applicable allowance. As explained below, however, MMS has not adopted a rule which would provide for deduction of certain extraordinary costs.

State commenters objected to the deduction of transportation allowances from value and particularly from the gross proceeds, especially if gross proceeds is considered a "minimum value." One of the commenters stated that the "less transportation allowances" language is particularly

confusing because "it suggests that lessees can deduct the allowance from the value determination" rather than as a separate line item as required by § 206.105(c)(4) of the final rule.

MMS Response: Section 206.102(a) provides that the value for royalty purposes is the value determined in accordance with § 206.102 (i.e., arm's-length gross proceeds or a value determined using benchmarks) less applicable allowances. The purpose of § 206.102(h) is to make it clear that, no matter what valuation method is used, the value for royalty purposes cannot be less than the lessee's gross proceeds less applicable allowances. Therefore, if a benchmark-derived value less applicable allowances is less than gross proceeds less applicable allowances, gross proceeds less applicable allowances is to be used as the value for royalty purposes. In either event, the lessee may be entitled to deduct transportation allowances to determine value, for royalty purposes, at the lease (unless the benchmark-derived value already is a value at the lease—in that even no further transportation allowance would be authorized.)

Section 206.102(i) was proposed as § 206.102(h). This section addresses the lessee's obligation to place lease production in marketable condition. Five industry commenters opposed the concept that the lessee is responsible for placing the product in marketable condition at no cost to the lessor and recommended specific deletion of language in the proposed regulation to accomplish this. One industry commenter recommended that the language "unless otherwise provided in the lease agreement" be added at the end of the first sentence, and another industry commenter pointed out that the lessor does share in marketable condition costs under net-profit-share leases.

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, MMS's policy and practice 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 oil 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 paragraphs (2)(i) or (2)(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 once approved, the allowance should 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 cases the royalty rate. The MMS has determined 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.

Section 206.102(j) was proposed as § 206.102(i). There were several comments on this section from industry, States, and Indians. The majority of the comments were negative in some respect; only two commenters (one industry and one State) concurred with the proposed regulation as written. State and industry commenters recommended deleting the regulation in its entirety, indicating that the regulation is inappropriate in the context of oil sales because the majority of oil is sold under monthly posted prices and is not normally subject to contractual price escalations or increments. They suggested that the regulation is more appropriate to gas sales contracts and does not belong as an oil valuation standard.

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.

MMS Response: Although the large majority of oil is sold under posted price bulletins, the division order, which sets forth the division of proceeds and is signed by all interest owners, is considered to constitute the "contract" for purposes of these regulations.

Several modifications, many taking issue with the "prudent operator" concept, were suggested as follows:

Two industry commenters suggested deleting the first sentence ("Value shall be based on the highest price a prudent operator can receive under its contract") because (1) it countermands the use of the actual proceeds benchmark system established in § 206.102 (b) and (c); and (2) the requirement of a lessee to obtain the highest theoretical price, regardless of the cost involved in obtaining that price, may contradict the definition of "prudent operator" found in the draft coal regulations at § 206.5(nn) and, therefore, ignores "the realities of the marketplace and the courthouse and unfairly precludes the lessee from exercising sound business judgment."

One industry commenter recommended revising the paragraph to conform to the reasonable value standard of § 206.102 generally. Here the commenter argued that the "highest price" standard of this subsection is in direct opposition to the reasonable value standards of previous subsections, thus causing the proposed rulemaking to be contradictory.

MMS Response: The MMS has modified the first sentence of the final rule to read "Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract." As noted in the preamble to the proposed rule, this section prescribes a diligence concept. As discussed above, with regard to the concept of gross proceeds "accruing" to a lessee, MMS requires a lessee to pay royalty on that value which it was entitled to get. These regulations reflect MMS's willingness generally to accept arm's-length contract prices as value, but there is a concomitant obligation on the part of the lessee to obtain all to which the lessee is entitled under its contract. If it fails to take such reasonable measures, MMS will assess royalty on the prices which reasonably could have been obtained in accordance with the contract.

One industry commenter suggested changing the fourth sentence to read "the lessee will owe no additional royalty *unless or* until monies are * * * received" in cases of disputed payments.

MMS Response: The MMS has adopted this suggested modification as consistent with its intent. However, this provision does not permit a lessee to avoid paying royalties where a purchaser has failed to pay, in whole or in part or timely, for a quantity of oil.

One State respondent suggested that an explicit provision for the assessment of interest for delayed payments should be added, with such a requirement being an equitable compromise for the lessor's agreement to delay enforcement of its rights to the timely payment of full royalties.

MMS Response: When a matter is being legally contested between the parties, and the lessee has taken appropriate legal action, MMS's policy is not to require payment of the amount in dispute until the lessee actually receives it. If a purchaser fails completely to pay for a volume of production, royalties still are due the month following the month of sale or other disposition. In all cases, interest is due if the royalties are paid late. However, in the case of disputed price increments, the royalties are not due until the end of the month following the month that the lessee receives them.

An Indian commenter also suggested that the last sentence should be clarified to make explicit that the bankruptcy of a purchaser of oil should not permit a lessee to avoid its royalty payment obligation.

MMS Response: The MMS believes that the language already encompasses a bankruptcy situation and recognizes that the lessee still has an obligation to pay its royalties.

Section 206.102(k) provides that no redetermination of value by MMS as the result of review, reconciliation, monitoring or a like process is final or binding against the lessor until the audit period is formally closed. MMS intends to issue additional guidelines as to when an audit period 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 206.102(l) was proposed as § 206.102(j). Comments were received from three State and six Indian representatives objecting to the restrictive terms/effect of this paragraph. In general, the comments pointed out that the requirement to obtain valuation information through Freedom of Information Act (FOIA) requests would inhibit Indian Tribes, allottees, and States from gaining access to the information required to assure that valuations are properly determined. In particular, "The second sentence of the proposed regulation appears to be an unlawful effort to preclude the exercise of departmental discretion under FOIA to voluntarily release nonproprietary data to royalty owners on a case-by-case basis. The third sentence appears to prohibit tribes and allottees from requesting such information through the BIA." It was generally recommended that the paragraph should be clarified to indicate that all valuation information should be available to States, Indian Tribes, and allottees without going through FOIA procedures. (Two Indian commenters offered specific language that could be appended to the paragraph to clarify its intent regarding the sharing of information with authorized parties.)

MMS Response: The intent of this paragraph was not to preclude access 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 lessor 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 206.103 Point of royalty settlement.

Several industry representatives and a few States commented on this section. The State commenters recommended that § 206.103 be strengthened by defining standards for establishing the point of royalty settlement and thereby minimizing pipeline losses. Lease or unit boundaries were suggested as the point of royalty settlement for onshore production, and the entrance to the first onshore facility was suggested for OCS production.

MMS Response: These regulations pertain to the valuation of oil and are not concerned with the criteria for the point of royalty settlement. The point of royalty settlement is authorized by MMS operations offices for Federal OCS leases and by BLM for onshore Federal and Indian leases.

Two industry commenters addressed the clarity and intent of § 206.103(a)(2). One of these commenters pointed out that the reference to an adjustment for differences in quality and quantity (such as for basic sediment and water) was unclear, asking what adjustments would apply and how these would be made. The other commenter recommended deleting the paragraph altogether because only the quantity and quality actually measured at the point of royalty settlement should be used for royalty computations.

MMS Response: The paragraph cannot be deleted because there are situations, usually onshore, where the gross proceeds accruing to a lessee are based upon the quantity and quality of oil at a point that is different than the point of royalty settlement specified by BLM to be used in calculating Federal or Indian royalty, usually at the tank battery on the lease. In this situation, the quantity and quality criteria measured at the tank battery on the lease must be used to determine the proper value, which, because the quantity of oil at the contractual sales point is less, will be greater than the lessee's gross proceeds.

Many commenters from industry objected to the provision of § 206.103(b)

disallowing actual or theoretical losses between the point of royalty settlement and the actual delivery point. They pointed out that pipeline losses are an integral part of transportation over which the lessees/operators have no control and thus should be an allowable component of transportation deductions. They also pointed out that disallowance of losses is contrary to the concept of accepting gross proceeds under arm's-length transactions because the lessor's royalty may be calculated on a different basis than what the lessee is paid by the purchaser.

MMS Response: The issue addressed here deals with volume and quality measurements upon which royalty must be based. The issue of line losses being included as a component of transportation deductions is addressed in the section of the regulations dealing with transportation (§§ 206.104 and 206.105).

One industry commenter suggested that § 206.103(b) be clarified regarding load oil, and recommended that the section be modified to specifically exclude load oil from royalty obligation.

MMS Response: The determination of whether or not load oil is considered to be royalty-bearing is a function of lease terms and the origin of the oil so used, and is generally the responsibility of the BLM and MMS OCS operations personnel for onshore and OCS leases, respectively. As such, no specific language was added to address this issue.

Section 206.104 Transportation allowances—general.

Comments on transportation allowances that did not relate to any specific section of the regulations were classified in the General section of the oil transportation regulations. Although there were comments on a wide variety of subjects, they have been grouped as follows: Post-production costs, validity issues, adequacy/inadequacy issues, cost issues, Royalty-In-Kind (RIK) issues, and issues relating to the definition of terms.

Many commenters addressed the issue of whether or not MMS should allow lessees to deduct all post-production costs from royalty payments. Transportation costs are one type of post-production cost. MMS will not respond to that issue again in this section because it was fully addressed in the discussion of § 206.102(i). Moreover, because the final rules provide an allowance for transportation costs, it is unnecessary to consider whether such costs also are to be considered "post-production costs."

Many commenters addressed 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.

Six State and five Indian commenters stated that transportation allowances should not be granted unless necessary to sell the product or to promote development, or unless the transportation results in a higher royalty value. Six Indian and one State commenter stated that MMS should not grant any transportation allowances under any circumstances.

One Indian commenter stated that the regulations should not be allowed to change the lease terms. According to this commenter, the granting of transportation allowances is, in effect, a change to the lease terms.

Two Indian commenters stated that MMS must take into account its responsibility to Tribes and allottees in preparing the regulations and must determine the fairness and reasonableness of all transportation allowances.

One industry commenter stated that the reason that MMS grants allowances is because certain Interior Board of Land Appeals (IBLA) decisions required that transportation be considered when determining product value on which royalty is based. Another industry commenter stated that MMS should grant a transportation allowance even if the product value is determined at the lease, if the sales contract required the lessee to incur the expense of transporting the oil to the point of sale.

MMS Response: On the basis of decisions by the Interior Board of Land Appeals (IBLA), Solicitor's opinions, and judicial decisions, it has been longstanding MMS policy to grant transportation allowances when oil is transported to a sales point off the lease in order to calculate the value of the product at the lease. Furthermore, the IBLA has ruled that transportation allowances must be granted for Indian leases. *Kerr-McGee Corp.*, 22 IBLA 124 (1975). Therefore, the regulations being adopted are consistent with past practice and are consistent with the Secretary's responsibility to the Indians. The MMS believes that royalty should be free of production and marketing costs. However, values may have to be adjusted for transportation and/or processing in determining value at the lease.

The MMS agrees that the proposed procedure for determining a transportation allowance places a great deal of reliance on the oil industry. However, this program will be under continuous review and oversight by MMS. There is nothing in the final oil transportation allowance regulations that would change the terms of any Indian lease. The MMS believes that the policy of granting transportation allowances is appropriate and should continue.

Another issue centered around the adequacy or inadequacy of the proposed oil transportation regulations in general. Some commenters believed that the regulations are completely flawed, while others pointed to specific instances where changes should be made to improve their specific applicability.

One industry commenter suggested that MMS should approve the use of contract prices which are net of transportation costs. Another industry commenter stated that the regulations should be revised to eliminate the alleged bias against frontier and deep-water areas. They also recommended the elimination of the ceiling on transportation allowances. Another industry commenter stated that the regulations should be modified to embrace both traditional and nontraditional transportation arrangements.

Two industry commenters stated that, in their view, the proposed regulations serve as a disincentive for companies to build and operate transportation facilities. One industry commenter stated that the oil transportation regulations should be revised to achieve certainty by adopting a more rational and realistic approach.

MMS Response: In response to comments received, MMS has changed the regulations to recognize that, in arm's-length situations where the specified price is reduced by a transportation factor, the lessee does not have to report the transportation factor as a transportation allowance. The MMS also recognizes that transportation costs for frontier and deep-water areas may be extraordinarily high and may exceed 50 percent of the value of oil. Because of this concern, MMS has adopted a provision in the final regulations to permit the transportation allowance to exceed the 50-percent limitation with approval from MMS. As the general rule, however, the transportation allowance authorized by the regulations may not exceed 50 percent of the value of the oil at the point of sale on the basis of a selling arrangement. The MMS has

decided that pre-approval of all transportation allowances is not a cost-effective procedure. 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.

The MMS received a number of comments relating to transportation allowances for RIK oil. Industry commenters stated that MMS should grant a transportation allowance for onshore RIK oil. Another industry commenter suggested that the regulations should clearly state that the lessee is not required to transport RIK oil from the lease. Other industry commenters stated that this section was in conflict with § 208.8 of the proposed RIK regulations.

MMS Response: The suggestion that MMS should grant a transportation allowance for onshore RIK oil was not adopted because the onshore lease terms provide that the in-kind oil will be made available to the lessor on the lease at no cost to the lessor. The MMS believes that there is no need to state explicitly that the lessee is not required to transport onshore RIK oil. Many of these issues will be addressed in MMS's revisions to the RIK regulations (See 52 FR 2202, January 20, 1987).

Another issue discussed by several commenters concerns the definition of terms used in the regulations. Several respondents commented on the use of the term "reasonable" to describe transportation costs. One State commenter recommended that the term "reasonable" was too vague and should be defined. Three industry commenters recommended that the term "reasonable" be deleted. Six commenters were concerned about the term "remote from the lease." Two Indian and two State respondents commented that the phrase "remote from the lease" should be defined. Two industry commenters stated that the phrase "remote from the lease" should be changed to "the 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 and includes the requirement that the transportation costs be necessary to market the oil. The MMS agrees that the phrase "remote from the lease" caused confusion and has replaced it with the phrase "off the lease."

The MMS received comments from a large number of respondents on § 206.104(b). This proposed regulation established a 50-percent limit on transportation allowances.

Most of the comments on this paragraph related to one major topic, the limitation of 50 percent on oil transportation allowances. Comments were also received on the proposal not to allow royalty payments to be reduced to zero. Comments on the 50-percent allowance issue were also divided between those commenters who wanted to retain the limit and add additional qualifications, those who wanted to raise the limit, and those who wanted to lower the limit.

Most industry commenters stated that MMS should abolish the 50-percent limitation for one or more of the following reasons: If the proposed limit is retained, the exception to the 50-percent limitation may not be exercised freely enough; the 50-percent limit could impose a serious economic deterrent to the exploration and development of frontier areas and could serve as a disincentive to the building of transportation systems; the limitation figure is strictly arbitrary and totally unjust to the lessee/working interest owners; it would be a rare case when an oil transportation cost would come close to the proposed 50-percent cap, much less exceed it; the proposed 50-percent cap is a deviation from the stated intent of MMS to base royalty valuation on "gross proceeds."

Industry commenters stated that MMS should approve requests for transportation allowances exceeding the 50-percent limitation upon submission of adequate documentation by the lessee for the following reason: If the actual cost of transportation can be reasonably justified, it should be permitted if a lessee can adequately demonstrate that a higher allowance is in the best interest of the lessor.

One Indian commenter stated MMS should change the 50-percent limitation to a 20-percent limitation because the 50-percent limit is excessively high.

Industry and State commenters stated that MMS should clarify the exception criteria which would allow transportation allowances to exceed the 50-percent limitation. The proposed "best interest of the lessor" criteria was described as vague and unclear and could be interpreted to exclude all cases. Criteria for approval should allow a lessee to more objectively plan development of oil and gas prospects.

Several industry respondents 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. This procedure should be applied to all transportation systems, but it would be especially important in the frontier areas.

A State, a State/Tribal association, and a few industry commenters stated that MMS should retain the 50-percent limitation in the proposed regulations for the following reasons: The limit should apply in all cases with no distinction made between circumstances where transportation is a component of price and where transportation costs are incurred directly by the lessee; the 50-percent limit is acceptable as a guideline but MMS should freely exercise its authority to allow transportation costs in excess of 50 percent of the value of the lease product; the 50-percent limitation provides incentive to keep costs under control while allowing some relief for legitimate hardship conditions.

One industry respondent and one State commenter stated that royalty payments should not be reduced to zero. The State respondent commented that it is a privilege to use public lands and it should not be possible to take production from it royalty-free. Two industry respondents stated that royalty payments should be allowed to go to zero for marginal production and for cases where reservoir maintenance is a concern.

MMS Response: The MMS has decided generally that the 50-percent limitation should be retained in the final rule. The transportation allowance for oil is limited to 50 percent of the value of the oil on the basis of a selling arrangement. 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. In no event, however, can the transportation allowance exceed 100 percent of the value of the oil.

MMS received comments that a 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" are sufficient to protect the lessor's interests.

The MMS received several comments from industry on § 206.104(c) which requires allocation of transportation costs among all products transported. One commenter stated that for transportation allowances, MMS should allocate costs on the basis of relative value rather than on the basis of relative volume. Two commenters recommended that costs associated with the transportation of nonroyalty-bearing

products (i.e., water) should be deductible. It was also stated that to the extent transportation for certain nonroyalty-bearing products cannot be avoided, the costs should be equally as deductible as the oil transportation. Four commenters recommended deleting the requirement that transportation costs must be allocated among all products for one or more of the following reasons: Allocation would be a labor-intensive process and an onerous burden inflicted upon reporting parties: allocation would be impractical because, in many instances, volumes are not available; and it would require significant additional effort to complete additional Forms MMS-4110.

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 has considered the comments regarding allocating costs on the basis of relative value. The MMS does not agree with the proposal that the costs of transporting nonroyalty-bearing substances should be included in a transportation allowance in all instances. However, upon review, MMS has recognized that there could be circumstances where 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 oil is necessary in order to transport the oil. For other than waste products, the final rule provides, however, that prior MMS approval is required before an allowance may be taken for the cost of transporting nonroyalty-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 not be difficult in most instances.

Section 206.105 Determination of transportation allowances.

(a) *Arm's-length transportation contracts.*

Although there were comments on a wide variety of subjects, they have been grouped under nine issues as follows: Acceptance of FERC-approved tariffs and 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, and period for filing a proposed allocation method.

(1) Acceptance of FERC-approved tariffs and arm's-length transportation agreements as an accurate indicator of reasonable, actual costs.

Several industry commenters responded that the oil transportation allowance regulations should be written to support the use of FERC-approved tariffs and arm's-length transportation agreements as an accurate indicator of reasonable, actual costs.

Indian commenters expressed serious concern about the validity of using arm's-length contracts as an indicator of value. One Indian commenter stated that arm's-length contracts are not a bona fide indicator of reasonable, actual costs. Another Indian commenter expressed doubt that there can even be an arm's-length contract between companies in the oil industry. One Indian commenter stated that arm's-length contracts should not be accepted unless a thorough analysis of lessee/purchaser affiliations is undertaken. Another Indian respondent 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 commenter also stated that MMS should establish appropriate criteria to determine the accuracy and reasonableness of allowances granted under arm's-length and non-arm's-length contract situations.

MMS Response: The MMS currently uses FERC-approved tariffs and arm's-length transportation agreements as an accurate indicator of reasonable, actual costs. In these final rules, for non-arm's-length and no-contract situations, MMS generally will permit only the reasonable, actual expenses incurred by the lessee as the allowance. For lessees who have tariffs approved by FERC or a State regulatory agency, MMS is creating an exception to this policy, discussed below in regard to § 206.105(b). MMS has added a sentence to § 206.105(a)(1) 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 § 206.105(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 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) The disallowance of a transportation deduction for a reporting period not covered by a Form MMS-4110, Oil Transportation Allowance Report.

The MMS received responses from several industry respondents stating that the disallowance of a transportation deduction for a reporting period not covered by a Form MMS-4110 is an excessive penalty for what they consider to be 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-4110 before the Form MMS-2014 is filed. However, one State commenter agreed with the proposed regulation disallowing the deduction for any period in which the Form MMS-4110 was not received.

Many industry commenters responded on this paragraph stating that the regulations should have a provision allowing retroactive transportation deductions. The general consensus was that a lessee does not always have the details on transportation worked out before production begins, and sometimes it is necessary to go back and revise data related to an allowance after agreements are reached because of the fast changing nature of current oil and gas markets.

MMS Response: The MMS considered the comments on retroactive requests and has revised the regulations, § 206.105 (a)(1) and (b)(1), to allow lessees to request transportation allowances retroactively for a period of not more than 3 months. Pursuant to § 206.105(d), if a lessee takes a deduction without complying with the regulations, interest only must be paid until the date that appropriate forms are filed. However, the lessee will be required to repay the amount of any deduction disallowed owing to the limitation on retroactivity.

(3) Prior MMS approval of transportation allowances.

Industry respondents expressed approval of the self-implementing procedure in the transportation allowance regulations. This was regarded as a method of relieving a considerable administrative burden on both industry and MMS. One Indian commenter disagreed with the self-

implementing nature of the regulations because it was regarded as a method of establishing the 50-percent limitation as a floor for transportation allowances.

State and Indian commenters stated that MMS should pre-approve all transportation allowances and should provide approval only on a showing of necessity to promote development or a showing that a higher value could be obtained for the oil at a point of sale away from the lease. It was also stated that neither the MMS nor the States and 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 has determined that it is not necessary to preapprove all transportation allowances. The MMS will monitor and review transportation allowances for regulatory compliance and reasonableness. Therefore, most allowances under *§ 206.105(a) and (b)* do not require prior MMS approval.

(4) Acceptance of transportation-reduced prices without requiring the filing of Form MMS-4110 for both arm's-length and non-arm's-length situations.

Industry commenters responded that MMS should accept transportation-reduced prices without requiring the filing of Form MMS-4110 for both arm's-length and non-arm's-length situations. This policy was regarded as reducing the administrative burden on industry and MMS. However, one commenter disagreed with this proposal because it was regarded as a potential technique to exceed the 50-percent limitation provision of the regulation. One commenter stated that neither industry nor MMS could administer trucking-rate transportation allowances on the basis of lease-by-lease and, therefore, MMS will probably be forced to accept transportation-reduced values where trucking is involved.

MMS Response: The MMS considered these comments and determined that § 206.105(a)(5) of the final rule should provide that transportation factors specified in arm's-length contracts are to be considered as reductions in value rather than transportation allowances. The use of Form MMS-4110 for the transportation factors is not required. 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 approval.

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

Two industry commenters responded that it would be administratively easier if the regulations would allow a current approved transportation allowance to remain in effect until it expires. Seven industry commenters stated that the transportation allowance reported on Form MMS-4110 should continue until the applicable contract or rate terminates or is modified or amended. State commenters stated that, owing to some allowances currently being taken without written MMS approval, only those lessees with documented approval should be allowed to continue without submission of the Form MMS-4110.

MMS Response: The MMS considered these comments and has revised the regulations at § 206.105(c)(1)(v) and (c)(2)(v) to provide that transportation allowances in effect on the date these regulations become effective will be allowed to continue until they terminate, subject to audit. However, MMS is limiting this provision only to those allowances that have written approval from MMS. Because the regulations are being revised to remove any prior approval by MMS before a deduction can be taken, and the submission of Form MMS-4110 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 requiring all allowances to be deducted under the new rules documented as of the effective date.

(6) Should MMS require the filing of Form MMS-4110 every 12 months?

Industry commenters stated that there is no benefit to MMS in submitting a form that duplicates information on file when a change has not occurred. Two industry commenters responded that there is no apparent reason for MMS requiring the filing of Form MMS-4110 every 12 months.

MMS Response: The MMS requires the annual filing of Form MMS-4110 for use in monitoring costs and volumes associated with a multi-million dollar transportation allowance program. The regulation is being adopted as proposed.

(7) Should MMS allow transportation allowances for production which is not royalty bearing?

An industry commenter recommended that a transportation allowance should include costs associated with moving water because some water is retained in pipeline oil. Another industry respondent recommended deletion of the last sentences of § 206.105(a)(2) and (b)(3) which prohibit disallowances for transporting lease production which is not royalty-bearing.

MMS Response: As discussed earlier, MMS has decided that it is appropriate to provide an allowance which includes the costs of transporting certain production, including waste products, which is not royalty bearing.

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

Two industry commenters 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 the basis of relative volume. One industry commenter suggested that MMS provide an alternative allocation procedure for situations which would require a variance from the proposed allocation method.

One State commenter suggested that MMS provide guidance on what will be an acceptable method of allocation in situations that involve the transportation of both gaseous and liquid products. One industry commenter suggested that the rules could be further enhanced by allowing for the adoption of an allocation procedure contained in a different arm's-length transportation contract where similar conditions and products exist.

MMS Response: The MMS has added a new paragraph which provides that, upon request of 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. It would be difficult for MMS to provide guidance on acceptable methods of allocation because of the many different situations involving the transportation of both gaseous and liquid products. The MMS believes that the most advantageous procedure is to have the lessee submit an allocation proposal to MMS in these situations. Thus, § 206.105(a)(3) and (b)(4) require the lessee to submit such an allocation proposal within prescribed timeframes.

(9) The MMS should extend the period to submit a proposed allocation method.

Two commenters stated that the requirement to submit a proposed allocation method within 60 days will create a significant workload and burden, and a more reasonable provision of time would be 120 days. Others requested an even longer period.

MMS Response: The MMS determined that 3 months is a reasonable time period to submit a proposed allocation method and § 206.105(a)(3) and (b)(4) have been revised accordingly.

(b) *Non-arm's length or no contract.*

The MMS received many comments on § 206.105(b), which applies to non-arm's-length or no-contract

transportation situations, from industry, industry trade groups, States, Indian Tribes, and a Federal agency. Most of the negative comments actually addressed § 206.104(a), and those comments generally expressed the belief that no transportation allowance of any kind should be granted by MMS.

The comments received on these paragraphs have been grouped into nine issues as follows: Acceptance of State or FERC tariffs, acceptance of comparable arm's-length contracts, use of a benchmark system, penalties, increase in estimated allowances, prior approval of allowances, allowable costs, rate of return, and retaining Alternatives 1 and 2 for return on capital.

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

Industry commenters 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 "rightfully rely on the expertise of FERC and State agencies which set pipeline tariffs to determine fair and reasonable transportation charges." It was also 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. One industry commenter stated that FERC tariffs should be accepted as an allowable deduction regardless of whether the transportation contract is arm's-length or non-arm's-length because the tariff represents the recognized value of the service.

One industry commenter stated that MMS should accept as a transportation allowance either a FERC tariff or the actual cost including a reasonable profit, whichever is higher. This would give the lessee an option that would be more fair than the single method prescribed by MMS.

Two industry commenters stated that MMS should require actual costs only when there was no pipeline or published tariff. The use of internal cost accounting to determine the value of a transportation allowance was believed to be at odds with the interests of the lessee.

MMS Response: After careful consideration, MMS has decided that, generally, for non-arm's-length or no-contract situations, the fairest and best way to determine transportation allowances is to allow actual, reasonable costs plus, if appropriate, an acceptable cost for the lessee's undepreciated capital equipment. However, MMS has concluded that where a lessee has a tariff approved by FERC or a State 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 nocontract situations. See discussion below.

(2) Should MMS accept comparable arm's-length contracts for determining transportation allowances?

Several industry respondents stated that MMS should accept comparable arm's-length contract costs as the transportation allowance. The costs incurred under comparable arm's-length contracts were described as the best indicator of the value of that service provided by the lessee in transporting oil to a market or to any other point where it could be sold.

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" 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 oil transportation allowances on actual, reasonable costs plus return on investment.

However, in an effort to simplify procedures for both the lessee and MMS, the regulations at § 206.105(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 analysis exists and the FERC or State regulatory agency has declined to investigate pursuant to MMS's 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 the transportation allowance be based on the market value of transportation service as determined under a benchmark system?

Many industry respondents stated that MMS should allow transportation deductions based on a benchmark system. These commenters suggested that MMS allow the lessee the market value of the transportation service on the basis of a benchmark system featuring arm's-length contracts and tariffs with cost accounting being used only as a last resort.

MMS Response: The MMS considered the benchmark valuation system featuring arm's-length contracts and FERC tariffs with cost accounting being used as a last resort. The MMS has not adopted this recommendation for the same reasons as cited in issue no. 2 above.

(4) Should a penalty be imposed for late submission of the Form MMS-4110?

An industry respondent commented that requiring lessees to file Forms MMS-4110 and MMS-2014 at the same time would impose an unfair penalty on lessees for being unable to complete Form MMS-4110 prior to the Form MMS-2014 reporting deadline and that there is no need to cancel all currently approved allowances. Two other industry commenters suggested that submittal of Form MMS-4110 be only on the basis of as-needed, pursuant to contract changes.

MMS Response: The MMS has reconsidered the reporting requirement that would deny the transportation allowance for those periods for which no Form MMS-4110 was filed. Pursuant to § 206.105(b)(1) of the final rules, a lessee may claim a transportation allowance retroactively for a period of 3 months from the first day of the month that the Form MMS-4110 is filed. However, if the lessee has taken an allowance before filing the form, it must pay interest from the date the allowance was taken until the form is filed. The lessee will also be required to repay the amount of any allowance which is disallowed owing to the 3-month limitation on retroactivity. See

§ 206.105(d). The proposal to retain all current allowances in effect until they expire was considered and it was decided that approved allowances (i.e., allowances approved in writing by MMS) in effect on the effective date of these rules will be allowed to continue in effect until they expire. See §§ 206.105(c)(1)(v) and 206.105(c)(2)(v).

(5) Should the estimated rate reported on Form MMS-4110 be allowed to increase over the prior period, if justified?

One industry commenter requested that the estimated rate be allowed to increase over the prior period, if justified. This respondent also recommended that the initial allowance be effective for a period greater or lesser than the 12 months to allow industry to convert to calendar year reporting. This would ease the administrative burden. Another industry commenter questioned the cost effectiveness of the two-step submission of estimates and corrections. This commenter recommended that any adjustment, plus or minus, be made prospectively only.

MMS Response: The recommendation to allow an estimated rate to increase over the actual rate for the prior period, if justified, has been addressed in the final regulations. Pursuant to § 206.105(c)(2)(iii), the lessee may use an estimate higher or lower than the previous year's actual rate if the lessee believes it is appropriate when submitting Form MMS-4110. The recommendation to adjust the initial reporting period to allow industry to convert to calendar year reporting has been considered and the regulations at § 260.105(c) have been revised to provide for calendar-year reporting.

(6) Should MMS require prior approval for allowances?

Industry respondents 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. Two State commenters proposed that MMS should require prior approval on non-arm's-length contract or no-contract deductions for transportation because adequate audit resources are not available to audit the allowances, and it is very likely that many leases will never be audited. One Indian commenter proposed that MMS require prior approval and audit to prevent abuse in the claiming of depreciation and overhead costs.

MMS Response: The MMS currently reviews and approves all transportation allowance requests and has considered pre-approval and pre-audit of transportation allowances. It has been decided that a more effective use of resources can be attained by doing exception processing on allowances and selectively reviewing certain allowances in depth to determine the propriety of the allowance reported by lessees on Form MMS-4110. Therefore, with limited exceptions, no prior approval of allowances will be required.

(7) Should costs other than reasonable actual costs be considered in calculating the transportation allowance?

A few industry respondents stated that MMS should revise the regulations to make an allowance for debt service and State and Federal income taxes. Three industry commenters recommended that MMS provide for a complete recovery of costs plus an acceptable profit for assuming the risks involved in undertaking the service function of transportation. One industry commenter recommended that MMS allow for administrative overhead beyond that which is directly associated with, or attributable to, the transportation system.

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. The proposal to extend the amount of overhead beyond that which is directly allocable or attributable to transportation is not acceptable. Administrative overhead or any other costs not directly associated with transportation are not allowed.

(8) What rate of return should be used to calculate return on depreciable investment?

Most industry respondents opposed the use of Moody's Aaa corporate bond rate as unrealistic and too low. One industry commenter stated that "There is no reason to equate pipeline risks with the highest rated, most secure debt rate." Two industry commenters stated that the proposed rate is very conservative and arbitrary and the general consensus of the parties was that the rate of return should be adequate to reflect the risks involved in the oil and gas business. Seven respondents stated that the Aaa rate is the absolute lowest borrowing rate available only to a few "blue chip" companies.

One industry respondent suggested four alternatives to Moody's Aaa bond rate: (1) Prime rate plus 5 percent; (2) one and one-half times the average 20-year treasury bill rate; (3) 150 percent of Moody's Aaa rate; or (4) the rate of return methodology adopted by FERC in Opinion No. 154-B. This industry commenter also stated that industry's position supports a rate of return plus additional points to reflect risk factors, and two other industry commenters suggested that the rate of return should include Federal income tax.

Several industry respondents recommended a rate of return based upon the cost of debt and equity financing. One party stated that "Assets are not financed by debt alone; equity financing must be included in the calculation of an actual and reasonable cost of capital * * *" and suggested a rate to account for equity financing and an alternative method for extraordinary circumstances based on the weighted-average cost of capital. Another industry commenter suggested that the proposed rate "* * * would not include any return on equity which is a significant portion of the capitalization of the pipeline." One industry commenter suggested "* * * a true rate of return for the risk involved and the cost of capital for both debt and equity." Another respondent suggested a rate based on "* * * both cost of credit and equity capital." One industry respondent stated that "Most firms receive funds from both debt and equity sources."

Two industry commenters proposed the prime rate plus 5 percent in accordance with the RMAC panel. Two industry respondents suggested the average 20-year Treasury Bill rate times 150 percent. Seven industry commenters recommended either the average 20-year Treasury Bill rate times 150 percent or the prime rate plus 5 percent as proposed by the Oil Valuation and Gas Valuation Panels, respectively. One industry respondent recommended the prime rate plus 7 percent. Another industry respondent suggested Moody's 20-year Baa rate plus 9 percent as an equitable rate of return. One industry commenter preferred the Treasury Bill rate times 150 percent if MMS fixes the rate at the time of initial investment, or the prime rate plus 5 percent if MMS redetermines the rate yearly. Another industry respondent suggested a 23-percent pre-tax rate of return. One industry commenter suggested that a risk component of from 5 to 7 points above the Aaa rate be adopted.

Two industry commenters stated that the limitation on the rate of return serves as an economic disincentive for lessees to invest in high-risk ventures, such as the frontier areas. Three industry respondents commented that a lessee affiliated with the pipeline would

be at a disadvantage under the proposed rate of return because it would not be competitive with other producers deducting a transportation allowance that includes risk factors.

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 construct transportation facilities. The MMS has examined the use of the corporate bond rate very carefully and has concluded that such rates are representative of the loan rates on sums of money comparable to that expected for the construction of transportation facilities.

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 oil that has already been discovered is a much different risk. The risk of default (financial risk) is considered in corporate bond rates. Considering the risks related to transportation systems, a rate of return that is 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, and Standard and Poor's bond rate.

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 206.105(b)(2)(v) has been revised accordingly in the final rule. However, because of the substantial and diverse comments on this issue, including several comments on the draft final rule that the BBB bond rate is not much better than the first proposal, MMS will issue a notice of proposed rulemaking to reconsider the applicable rate of return for purposes of these regulations.

The MMS does not consider State and Federal income taxes as an appropriate expense that should be included in a transportation allowance and does not agree that the rate of return should be increased to allow for income tax liability.

(9) Should MMS retain the provisions of both Alternative 1 and Alternative 2?

Some industry respondents commented that MMS should retain both Alternative 1 and Alternative 2 in proposed § 206.105(b)(5)(iv). One industry commenter recommended that both Alternatives 1 and 2 be included in any cost-based methodology for determination of a transportation allowance. Another industry commenter recommended that both alternatives 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 respondents stated that MMS should retain Alternative 1. One industry commenter stated that it endorsed use of the first alternative because it gives lessees some latitude in choosing the depreciation method.

One industry respondent commented that MMS should not retain Alternative 2. The commenter stated that this alternative would encourage third parties to become involved in the pipeline business, in which case MMS would absorb the full market cost of transportation provided.

Several industry respondents commented that MMS should adopt Alternative 2 and apply it to all existing and future transportation facilities. One commenter stated that limiting Alternative 2 (return on initial capital investment) to new or newly acquired transportation systems is unsupported in the proposed rules and Alternative 2 should be available without the limitation imposed by the MMS. Two industry commenters stated that they presumed Alternative 2 has no limit on the deduction under this alternative. Both industry commenters stated that although Alternative 1 specifically states that a transportation system may be depreciated only once, there is no mention of such a cap on Alternative 2 and, therefore, it is presumed that this option has no limit. One industry commenter stated that it believed it was appropriate to include both Alternative 1 and Alternative 2 in any cost-based methodology for determination of a transportation allowance.

One industry respondent recommended that MMS permit the depreciation schedule to be adjusted to reflect additional capital investment of a subsequent purchaser because, if additional capital is invested, there is no double recoupment of capital investment.

Several industry commenters stated that MMS's proposal to disallow recapitalization is inequitable. One commenter stated that because this proposal would only recognize the original capital costs, the additional capital costs which may have been invested by the new owner may not be recovered.

Some industry respondents stated that, although they agreed with the concept of allowing a rate of return on the transportation facilities, the application of the allowance is unfair insofar as a company using Alternative 1 (i.e., one with existing facilities) would only be receiving a return on investment for the undepreciated investment (or net book value).

Some industry respondents stated that MMS should not tie the rate of return to a diminishing value. Both commenters stated that because the intention is to provide the lessee with a rate of return for his invested capital he should not be penalized by a diminishing return caused by tying the return into a depreciation option.

Several industry commenters stated that MMS should allow a lessee to add estimated abandonment costs to its depreciable capital investment value. One industry commenter stated that, although MMS has set out that the proposed regulations require recognition of salvage values, often the cost of abandonment exceeds any salvage value; consequently, it was suggested that the estimated cost of abandonment of the transportation system be included as an expense of operation to the lessee.

An industry commenter stated that a transportation system should be depreciated only once. The commenter suggested that the regulation state "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."

MMS Response: The MMS has reviewed the comments received regarding both Alternative 1 and Alternative 2 in proposed § 206.105(b)(5)(iv) and concluded that both alternatives should be retained. However, under the final rule, § 206.105(b)(2)(iv), 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 oil 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 MMS has taken the position that, because it does not participate in the profit or losses that could result from the sale of transportation facilities, no costs for dismantling and abandonment should be included in transportation allowances.

The final rules provide that a transportation system may be depreciated only once, and that the depreciation schedule established by the original transporter/lessee may not be altered by a change in ownership.

(c) *Reporting requirements.*

The MMS received many comments from industry and Indians on the reporting requirements, § 206.105(c), in addition to the comments already discussed above. The two major issues of concern relating to the reporting requirements were (1) usage of Form MMS-4110, and (2) the terms of the allowance and reporting periods.

(1) Should MMS require the filing of Form MMS-4110?

Several industry and Indian commenters opposed the use of Form MMS-4110. One Indian commenter stated that there should be more monitoring of deductions taken from royalty and requested that MMS retain an approval process instead of the mere filing of Form MMS-4110. One industry commenter stated that Form MMS-2014 will show the transportation allowance taken and that Form MMS-4110 is unnecessary. Two industry commenters recommended the filing of an "Intent to Deduct Transportation." One industry commenter stated that the transportation costs under arm's-length contracts should be part of the value and Form MMS-4110 should be filed only for non-arm's-length transportation.

Many industry commenters stated that it would be burdensome to file a new Form MMS-4110 each time a trucking charge or similar net change occurred in a contract price. One industry commenter stated that price postings have been amended as often as three times per month. One industry commenter suggested that Addendum No. 15 be incorporated into the new regulations and expanded to include offshore leases. One industry commenter stated that the regulations are not clear about whether or not a Form MMS-4110 must be filed for prices net of transportation. This industry commenter also stated that in some situations the lessee may not know a price is being netted of transportation in time to file Form MMS-4110.

One Indian commenter stated that the information on Form MMS-4110 should be clear and uncomplicated and should be available to the Indians.

MMS Response: The MMS believes that Form MMS-4110 must be 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 pre-approval of the allowances. The MMS has made the information on Form MMS-4110 as clear and uncomplicated as possible considering the complex nature of transportation allowances. The information on these forms will be made available to the Indians upon proper request. The filing of a Form MMS-4110 equates to an "intent to deduct transportation." The transportation costs under an arm's-length contract are separate from the value determination under such a contract so a Form MMS-4110 should be filed for transportation costs determined under both arm's-length and non-arm's-length contracts.

In arm's-length situations where the purchaser is reducing the posted price for a transportation cost and the lessee is incurring no out-of-pocket expense, filing a Form MMS-4110 is unnecessary. In these situations, the point of sale is at the point the purchaser acquires the oil and, 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 oil, the reduction of price for the transportation costs past the point of sale would be considered. Section 206.105(a)(5) of the final rule incorporates the necessary regulatory language.

(2) Term of the allowance periods and the timetable for reporting.

One industry commenter endorsed the 12-month term for both onshore and offshore leases. Another industry commenter strongly suggested that all transportation allowances based on cost accounting be determined on the basis of calendar-year reporting. This industry respondent also suggested that all existing transportation allowances based on cost accounting be extended until April 1, 1988, when data for the 1987 allowance would be submitted.

Other industry commenters opposed the termination of all current allowances and recommended continuing allowances in effect for a period of time beyond the effective date of the regulations to allow for smooth transition. The general consensus was that it would be an administrative burden to require the filing of Form MMS-4110 immediately upon passage of the rulemaking. In addition, two of these four industry respondents proposed that the transportation allowances remain in effect for an additional 90 days beyond the issuance date of the regulations. One of these commenters suggested filing new forms only when the current allowance expires.

One industry commenter recommended a grace period for filing all allowances. Another industry commenter proposed a 90-day filing period for new Forms MMS-4110 that are submitted for contract revisions.

MMS Response: The MMS concurs with a 12-month term and the final regulations, in § 206.105(c), have been changed to provide that a Form MMS-4110 will be filed by calendar year. The MMS considered extending current allowances and § 206.105 (c)(1)(v) and (c)(2)(v) now provide that certain allowances will continue in effect until they expire. These are limited to allowances approved in writing by MMS. In regard to a grace period for filing, the regulations have been revised to allow a grace period of 3 months for all non-arm's-length and no-contract situations. The regulations in § 206.105(c)(2)(iii) allow the lessee 3 months after the end of the previous reporting period to file the Form MMS-4110, during which period the lessee will continue to use its previous allowance. Also, the final regulations at § 206.105 (a)(1) and (b)(1) have been revised to 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-4110 is filed with MMS. Therefore, even if the lessee is not able to file the Form MMS-4110 timely, the lessee could file the Form MMS-4110 and claim the transportation allowance on a corrected Form MMS-2014 at a later date. The rules also have been modified to include in paragraphs (c)(i)(vi) and (c)(2)(vii) a provision to allow MMS to establish reporting requirements different from those specified in the rules where circumstances warrant.

The MMS has received some comments on the Form MMS-4110. Those comments will be considered in revising the final forms.

(d) *Adjustments.*

Several industry respondents commented on § 206.105(e), which was proposed as § 206.105(d), and pertains to adjustments. Four principal issues were identified.

(1) Should MMS require retroactive adjustments to transportation allowances?

It was the general consensus in the comments that adjustments were a very large burden on both industry and the MMS and that some way should be found to eliminate the need for the many adjustments that result from differences between actual and estimated transportation allowances. Six 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 greatly relieve the administrative burden on MMS and industry. Three industry commenters recommended that actual data from one period be used as the allowance for the subsequent period, eliminating the need for adjustments. It was stated also that this procedure would relieve the burden on MMS and industry associated with the requirement to make adjustments to each account, each month, for each year.

MMS Response: To ease the burden resulting from the adjustments requirement, MMS has eliminated the need for many retroactive adjustments by accepting arm's-length-contract transportation costs when the lessee timely files the Form MMS-4110. For non-arm's-length and no-contract situations, MMS did not eliminate the need for adjustments between actual and estimated transportation allowances. 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 actual allowance, but determined that either procedure could be inequitable to lessees, MMS, Indian Tribes, and Indian allottees. However, because many lessees now will be able to use FERC tariffs for non-arm's-length transportation allowances, retroactive adjustments will be further reduced.

(2) Should MMS require refunds to be requested under the refund procedure requirement of section 10 of the Outer Continental Shelf (OCS) Lands Act?

An industry commenter stated that refunds for estimates tendered in excess of actual costs should not be judged as refunds of a payment of royalty under section 10 of the OCS Lands Act, 43 U.S.C. 1339, because estimates are not "actual" payments of royalty. Overpayments could then be treated as line-item adjustments not subject to the refund process. Two industry respondents 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 to industry and MMS. Two industry commenters stated that the current long review and audit process is now causing lessees to lose the time value of money in the refunds which are due the lessees under section 10 of the OCS Lands Act. Audits on such refunds were described as fruitless and wasteful and the suggestion was made that MMS should consider transportation allowance adjustments to be exceptions to the refund requirements of Section 10 of the OCS Lands Act. Overpayments would be recovered through line-item adjustments on Form MMS-2014.

Two industry commenters suggested that the submission of Form MMS-4110 should constitute the tolling of the 2-year statute of limitations period defined in section 10 of the OCS Lands Act. These parties believed that this should be put in the regulations to avoid burdensome refund procedures.

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

(3) Payment of interest.

Industry commenters stated 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.

MMS Response: MMS has no legal authority to pay interest.

(f) *Actual or theoretical losses.*

The MMS received over 15 industry comments on § 206.105(f), which was proposed as § 206.105(e). All commenters basically stated that MMS should amend or delete this paragraph to allow actual or theoretical losses as a transportation cost.

Nine industry respondents stated that line losses are actual transportation costs which should be allowed by MMS. The basic premise of these comments was that all costs resulting from line losses should be deductible because, if MMS does not absorb its pro rata share of such transportation costs, an inequity results.

As a variation of this issue, eight industry commenters declared that only certain oil losses should be deductible from royalty. Other industry respondents commented that line losses in arm's-length contracts and FERC tariffs should be allowed. One of these commenters 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. In other words, the losses are part of the total cost of the transportation arrangement and should be deductible. Three industry commenters stated that MMS should allow those line losses not attributable to negligence. One of these commenters stated that a credit should be allowed for line losses not attributable to negligence and such change would conform to Section 308 of the FOGRMA, which specifies that a lessee is liable for royalty payments on oil and gas lost or wasted from a lease site when such loss or waste is because of negligence on the part of the operator of the lease.

One industry commenter stated that producer-owned pipelines should include transportation losses as part of operating expenses in the formulation of an allowance.

MMS Response: All of the issues of theoretical and actual line losses have been considered at length by MMS. The MMS will include, as part of a transportation allowance under an arm's-length contract, amounts required to be paid in cash or in-kind for line losses. However, 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 or no-contract situations. However, if any tariff approved by FERC or a State regulatory agency is authorized to be used for a non-arm's-length transportation allowance situation, any component of that tariff for actual or theoretical losses will be allowed.

(g) *Other transportation cost determinations.*

Only a few comments were received on § 206.105(g), which was proposed as § 206.105(f). This section allows use of the transportation allowance rules where transportation is a component of a valuation procedure such as a net-back.

The major concern raised about this paragraph was the application of the transportation allowance regulations to a net-back valuation. Two industry commenters stated that the use of restrictive cost-based transportation allowances is inequitable when the net-back valuation procedure is used and recommended that the section be reworded to recognize total "actual costs" incurred to move or improve the hydrocarbon for sale downstream.

MMS Response: The MMS has reviewed and analyzed the comments relating to the procedure for netting

costs back to the lease to determine a value for royalty purposes. The MMS remains convinced that the cost-based allowance procedure for determining oil transportation allowances is appropriate for determining value under a netback procedure. If there is an applicable FERC tariff, upon application by the lessee, that could be used instead.

Section 207.5 Contract and sales agreement retention.

Two comments were received regarding § 207.5 (formerly proposed as § 207.4), one from industry and one from a State. The State commenter suggested several modifications to clarify and insure that sufficient documentation on oil sales is maintained and made available to FOGRMA-authorized State auditors and other authorized personnel.

The industry commenter suggested that the regulations should limit the audit period, and thus the time for record retention, to six years. This would avoid "an unnecessary administrative burden" upon industry to maintain records for an indefinite period.

MMS Response: The MMS has modified the final rule to require lessees to maintain and make available all documents relevant to the valuation of production.

This subpart is not the appropriate place to address record retention requirements. The record retention provisions are found at § 212.51 (a) and (b).

Section 3162.7–4 Royalty rates on oil; sliding and step-scale leases (public land only).

This section was proposed as § 202.101. The Bureau of Land Management (BLM) advised that "the redesignation into 43 CFR must be accomplished prior to finalization of the proposed MMS regulations under 30 CFR Part 202 because the well count regulations (43 CFR Part 3100) must be referenced in the new 30 CFR Part 202." The BLM recommended extensive changes in this part "regardless of whether these regulations remain under 30 CFR or are reassigned to 43 CFR."

MMS Response: No changes to the proposed section will be made in the final rule. However, because this regulation is the responsibility of the BLM, it is being redesignated as 43 CFR 3162.7–4. After redesignation, BLM may elect to make certain revisions. MMS has corrected typographical errors which appeared in the proposed rule.

V. Procedural Matters

Executive Order 12291

The Department of Interior (DOI) has determined that this document is not a major rule and does not require a regulatory analysis under Executive Order 12291. This rulemaking consolidates Federal and Indian oil royalty valuation regulations; clarifies DOI oil royalty valuation and oil transportation allowance policy; and provides 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 the 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.*).

Lessee reporting requirements will increase approximately $4 million. All oil posted price bulletins or sales contracts will be required to be submitted only upon request, or only in support of a lessee's valuation proposal in unique situations rather than routinely, as under the existing regulations.

Paperwork Reduction Act of 1980

The information collection and recordkeeping requirements located at §§ 206.105, 207.5, and 210.54 of this rule have been approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3504(h), and assigned OMB Clearance Number 1010–0061.

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 203

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.

30 CFR Part 207

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 210

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 241

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

43 CFR Part 3100

Government contracts, Land Management Bureau, Mineral royalties, Oil and gas exploration, Public lands-mineral resources, Reporting and recordkeeping requirements, Surety bonds.

43 CFR Part 3160

Government contracts, Indian-lands, Land Management Bureau, Mineral royalties, Oil and gas exploration, Penalties, 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, 203, 206, 207, 210, 241, and 43 CFR Parts 3100 and 3160 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. Part 202 is amended by revising the Part title and the titles of Subparts B, C, D, E, F, G, and H to read as follows:

PART 202—ROYALTIES

Subpart B—Oil, Gas, and OCS Sulfur, General

Subpart C—Federal and Indian Oil

Subpart D—Federal and Indian Gas—[Reserved]

Subpart E—Solid Minerals, General—[Reserved]

Subpart F—Coal—[Reserved]

Subpart G—Other Solid Minerals—[Reserved]

Subpart H—Geothermal Resources—[Reserved]

3. A new Subpart I is added to read:

Subpart I—OCS Sulfur—[Reserved]

§§ 202.100, 202.101, 202.102, 202.103 [Removed]

§§ 202.150, 202.151 and 202.152 [Redesignated as §§ 202.100, 202.53 and 202.52 respectively]

4. Sections 202.100, 202.101, 202.102 and 202.103 under old Subpart C are removed. Sections 202.150, 202.151 and 202.152 under old Subpart D are redesignated as new §§ 202.100 under new Subpart C, 202.53 and 202.52 under new Subpart B, respectively.

5. Subpart B is revised to read as follows:

Subpart B—Oil, Gas, and OCS Sulfur, General

Sec.
202.51 Scope and definitions.
202.52 Royalties.
202.53 Minimum royalty.

Subpart B—Oil, Gas, and OCS Sulfur, General

§ 202.51 Scope and definitions.

(a) This subpart is applicable to Federal and Indian (Tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation, Osage County, Oklahoma) and OCS sulfur leases.

(b) The definitions in Subparts C, D, and I of Part 206 of this Title are applicable to Subparts B, C, D, and I of this part.

§ 202.52 Royalties.

(a) Royalties on oil, gas, and OCS sulfur shall be at the royalty rate specified in the lease, unless the Secretary, pursuant to the provisions of the applicable mineral leasing laws, reduces, or in the case of OCS leases, reduces or eliminates, the royalty rate or net profit share set forth in the lease.

(b) For purposes of this subpart, the use of the term "royalty(ies)" includes the term "net profit share(s)".

§ 202.53 Minimum royalty.

For leases that provide for minimum royalty payments, the lessee shall pay the minimum royalty as specified in the lease.

6. Subpart C is revised to read as follows:

Subpart C—Federal and Indian Oil

Sec.
202.100 Royalty on oil.
202.101 Standards for reporting and paying royalties.

Subpart C—Federal and Indian Oil

§ 202.100 Royalty on oil.

(a) Royalties due on oil production from leases subject to the requirements of this part, including condensate separated from gas without processing, shall be at the royalty 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 Part 206 of this title multiplied by the royalty rate in the lease.

(b)(1) All oil (except oil unavoidably lost or used on, or for the benefit of, the lease, including that oil 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 part applies is subject to royalty.

(2) When oil 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 the 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 section, the lease terms shall govern to the extent of that inconsistency.

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

(d) If a lessee receives insurance compensation for unavoidably lost oil, 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 agreement production attributable to its 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 though 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 purposes 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 when 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) persons with an interest in the agreement, including, to the extent practical, 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.

§ 202.101 Standards for reporting and paying royalties.

Oil volumes are to be reported in barrels of clean oil of 42 standard U.S. gallons (231 cubic inches each) at 60°F. When reporting oil volumes for royalty purposes, corrections must have been made for Basic Sediment and Water (BS&W) and other impurities. Reported American Petroleum Institute (API) oil gravities are to be those determined in accordance with standard industry procedures after correction to 60°F.

PART 203—RELIEF OR REDUCTION IN ROYALTY RATE

1. The authority citation for Part 203 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. Part 203 is amended by revising the titles of Subparts B, C, D, E, F, G, and H to read as follows:

Subpart B—Oil, Gas and OCS Sulfur, General

Subpart C—Federal and Indian Oil—[Reserved]

Subpart D—Federal and Indian Gas—[Reserved]

Subpart E—Solid Minerals, General—[Reserved]

Subpart F—Coal

Subpart G—Other Solid Minerals—[Reserved]

Subpart H—Geothermal Resources—[Reserved]

3. A new Subpart I is added to read:

Subpart I—OCS Sulfur—[Reserved]

§ 203.100 [Removed]

§ 203.150 [Redesignated as § 203.50]

§ 203.200 [Redesignated as § 203.250]

4. Section § 203.100 under old Subpart C is removed. Section 203.150 under old Subpart D is redesignated as § 203.50 under new Subpart B. Section 203.200 under old Subpart E is redesignated as § 203.250 under new Subpart F.

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. Part 206 is amended by revising the titles of Subparts B, C, D, E, F, G, and H to read as follows:

Subpart B—Oil, Gas, and OCS Sulfur, General—[Reserved]

Subpart C—Federal and Indian Oil

Subpart D—Federal and Indian Gas—[Reserved]

Subpart E—Solid Minerals, General—[Reserved]

Subpart F—Coal—[Reserved]

Subpart G—Other Solid Minerals—[Reserved]

Subpart H—Geothermal Resources

3. A new Subpart I is added to read:

Subpart I—OCS Sulfur—[Reserved]

§§ 206.300 and 206.301 [Redesignated as §§ 206.350 and 206.351]

4. Sections 206.300 and 206.301 under old Subpart G are redesignated as new §§ 206.350 and 206.351 under new Subpart H, respectively.

§ 3162.7-4 [Redesignated as 3167.7-5]

§ 206.103 [Removed]

§ 206.104 [Redesignated as 3162.7-4]

5. 43 CFR 3162.7-4 is redesignated as 43 CFR 3167.7-5. 30 CFR 206.103 is removed and 30 CFR 206.104 is redesignated as new 43 CFR 3162.7-4.

6. Subpart C is amended by adding new §§ 206.103 and 206.104 and by revising §§ 206.100, 206.101, 206.102, and 206.105 to read as follows:

§ 206.100 Purpose and scope.

(a) This subpart is applicable to all oil production from Federal and Indian (Tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation, Osage County, Oklahoma). 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, or 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 statute, treaty, lease 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.

§ 206.101 Definitions.

For the purposes of this subpart:

"Allowance" means an approved or an MMS-initially accepted deduction in determining value for royalty purposes.

"Transportation allowance" means an allowance for the reasonable, actual costs incurred by the lessee for moving oil to a point of sale or point of delivery off the lease, unit area, or communitized area, 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 market place 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.

"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.

"Gathering" means the movement of lease production to a central accumulation 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 offshore 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 the oil. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor. Gross proceeds, as applied to oil, also includes, but is not limited to reimbursements, including, but not limited to, reimbursements for harboring or terminalling fees. 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. Payment 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.

"Load oil" means any oil which has been used with respect to the operation of oil or gas wells for wellbore stimulation, workover, chemical treatment, or production purposes. It does not include oil used at the surface to place lease production in marketable condition.

"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 workback method) means a method for calculating market value of oil at the lease. Under this method, costs of transportation, processing, or manufacturing are deducted from the proceeds received for the oil and any extracted, processed, or manufactured products, or from the value of the oil or 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 profit share" (for applicable Federal and Indian lessees) means the specified share of the net profit from

production of oil and gas as provided in the agreement.

"Oil" means a mixture of hydrocarbons that existed in the liquid phase in natural underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities and is marketed or used as such. Condensate recovered in lease separators or field facilities is considered to be oil. For purposes of royalty valuation, the term tar sands is defined separately from oil.

"Oil shale" means a kerogen-bearing rock (i.e., fossilized, insoluble, organic material). Separation of kerogen from oil shale may take place in situ or in surface retorts by various processes. The kerogen, upon distillation, will yield liquid and gaseous hydrocarbons.

"Outer Continental Shelf (OCS") means all submerged lands lying seaward and outside of the area of lands 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 specified in publicly available posted price bulletins, offshore or onshore terminal postings, or other price notices net of all adjustments for quality (e.g., API gravity, sulfur content, etc.) and location for oil 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.

"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 oil are made. Selling arrangements are described by illustration in the MMS Royalty Management Program (Oil and Gas or Solid Minerals) Payor Handbook.

"Spot sales agreement" means a contract wherein a seller agrees to sell to a buyer a specified amount of oil 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.

"Tar sands" means any consolidated or unconsolidated rock (other than coal, oil shale, or gilsonite) that either contains a hydrocarbonaceous material with a gas-free viscosity greater than 10,000 centipoise at original reservoir temperature, or contains a hydrocarbonaceous material and is produced by mining or quarrying.

§ 206.102 Valuation standards.

(a)(1) The value of production, for royalty purposes, of oil from leases subject to this subpart shall be the value determined pursuant to this section less applicable allowances determined pursuant to this subpart.

(2)(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 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 oil production from the same field. The major portion will be calculated using like-quality oil 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 oil 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 1 barrel of the oil (starting from the bottom) is sold.

(b)(1)(i) The value of oil 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, oil 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 oil. If the contract does not reflect the total consideration, then the MMS may require that the oil 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 two 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 oil production be valued pursuant to the first applicable of paragraph (c)(2), (c)(3), (c)(4), or (c)(5) 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. If the oil production is then valued pursuant to paragraph (c)(4) or (c)(5) of this section, the notification requirements of paragraph (e) of this section shall apply.

(2) The 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 oil.

(c) The value of oil production from leases subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following paragraphs:

(1) The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area); provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of posted prices or oil sales contract prices, the following factors shall be considered: Price, duration, market or markets served, terms, quality of oil,

volume, and other factors as may be appropriate to reflect the value of the oil. If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume-weighted average price for the purchases or sales for the production month reported on Form MMS-2014 will be used;

(2) The arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);

(3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby areas;

(4) Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area), and other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil;

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

(6) For purposes of this paragraph, the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred.

(d) 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 production sold, purchased, or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

(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) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(4) or (c)(5) 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)(4) or (c)(5) of this section and each time there is a change from one to the other of these two methods.

(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 the 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 value for royalty payment purposes until MMS issues a value determination. The lessee shall submit all available data relevant to its proposal. 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 oil in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement or this section. 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 oil 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 oil.

(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 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 laws 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 to which 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.

§ 206.103 Point of royalty settlement.

(a)(1) Royalties shall be computed on the quantity and quality of oil as measured at the point of settlement approved by BLM or MMS for onshore and offshore leases, respectively.

(2) If the value of oil determined pursuant to § 206.102 of this subpart is based upon a quantity and/or quality different from the quantity and/or quality at the point of royalty settlement

approved by the BLM for onshore leases or the MMS for offshore leases, the value shall be adjusted for those differences in quantity and/or quality.

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

(c) Except as provided in paragraph (b) of this section, royalties are due on 100 percent of the volume measured at the approved point of royalty settlement. There can be no reduction in that measured volume for actual losses beyond the approved point of royalty settlement or for theoretical losses that are claimed to have taken place either prior to or beyond the approved point of royalty settlement. Royalties are due on 100 percent of the value of the oil as provided in this part. There can be no deduction from the value of the oil for royalty purposes to compensate for actual losses beyond the approved point of royalty settlement or for theoretical losses that are claimed to have taken place either prior to or beyond the approved point of royalty settlement.

§ 206.104 Transportation allowances—general.

(a) Where the value of oil has been determined pursuant to § 206.102 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:

(1) Transport oil from an onshore lease to the point off the lease: provided, however, that for onshore leases, no transportation allowance will be granted for transporting oil taken as Royalty-In-Kind (RIK); or

(2) Transport oil from an offshore lease to the point off the lease: provided, however, that for oil taken as RIK, a transportation allowance shall be provided for the reasonable, actual costs incurred to transport that oil to the delivery point specified in the contract between the RIK oil purchaser and the Federal Government or Indian lessor.

(b)(1) Except as provided in paragraph (a)(2) of this section, the transportation allowance deduction on the basis of a selling arrangement shall not exceed 50 percent of the value of the oil at the point of sale as determined pursuant to § 206.102 of this subpart. Transportation costs cannot be transferred between selling arrangements or to other products.

(2) Upon request of a lessee, MMS may approve a transportation allowance deduction in excess of the limitation prescribed by paragraph (b)(1) of this section. The lessee must demonstrate that the transportation costs incurred in excess of the limitation prescribed in paragraph (b)(1) 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.

(c) Transportation costs must be allocated among all products produced and transported as provided in § 206.105. Transportation allowances for oil shall be expressed as dollars per barrel.

(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.

§ 206.105 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 oil 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-4110 (and Schedule 1), Oil 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-4110 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 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.

(2)(i) If an arm's-length transportation contract includes more than one liquid product, and the transportation costs attributable to each product cannot be determined from the contract, then the total transportation costs shall be allocated in a consistent and equitable manner to each of the liquid 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 liquid products (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. The 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 product cannot be determined from the contract, the lessee shall propose an allocation procedure to MMS. The lessee may use the oil transportation allowance determined in accordance with its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all available data to support its proposal. The initial proposal must be submitted 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 oil 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 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.

(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-arms-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-4110 in its entirety 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-4110 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 determine whether lessees are taking deductions that 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-arms-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 capital 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 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 on 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 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 liquid product is transported, allocation of costs to each of the liquid products transported shall be in the same proportion as the ratio of the volume of each liquid product (excluding waste products which have no value) to the volume of all liquid products (excluding waste products which have no value) and such allocation shall be made in a consistent and equitable manner. Except as provided in this paragraph, the lessee may not take an allowance for transporting lease production 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. The 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 oil transportation allowance determined in accordance with its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all available data to support its proposal. The initial proposal must be submitted 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 oil transportation allowance on the basis of 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 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 arm's-length transportation charges, MMS shall deny the exception request if: (i) No FERC or State regulatory agency cost analysis exists and the FERC or State regulatory agency, as applicable, has declined to investigate pursuant to MMS timely objections upon filing; and (ii) 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-4110 (and Schedule 1), Oil Transportation Allowance Report, 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-4110 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-4110 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-4110 (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-4110 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. A Form MMS-4110 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-4110 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 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-4110 containing the actual costs for the previous reporting period. If oil transportation is continuing, the lessee shall include on Form MMS-4110 its estimated costs for the next calendar year. The estimated oil 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 that will affect the allowance. MMS must receive the Form MMS-4110 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-4110 shall include estimates of the allowable oil 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 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-4110. 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 paragraph (b)(5) 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 lessees 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) 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 for 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 production from Federal OCS leases, if the lessee's estimated costs were more than the actual costs, the lessee must submit a corrected Form MMS2014 to reflect actual costs together with its payment, in accordance with instructions provided by MMS. If the lessee's estimated costs were less than its 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 oil 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 netback valuation procedure or any other procedure that requires deduction of transportation costs.

30 CFR Part 207 is revised to read as follows:

PART 207—SALES AGREEMENTS OR CONTRACTS GOVERNING THE DISPOSAL OF LEASE PRODUCTS

Subpart A—General Provisions

Sec.
207.1 Required recordkeeping.
207.2 Definitions.
207.3 Contracts made pursuant to new form leases.
207.4 Contracts made pursuant to old form leases.
207.5 Contract and sales agreement retention.

Subpart B—Oil, Gas and OCS Sulfur, General [Reserved]

Subpart C—Federal and Indian Oil [Reserved]

Subpart D—Federal and Indian Gas [Reserved]

Subpart E—Solid Minerals, General [Reserved]

Subpart F—Coal [Reserved]

Subpart G—Other Solid Minerals [Reserved]

Subpart H—Geothermal Resources [Reserved]

Subpart I—OCS Sulfur [Reserved]

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.

Subpart A—General Provisions

§ 207.1 Required recordkeeping.

The recordkeeping requirements contained in this part have been approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3501 et seq. and assigned OMB Clearance Number 1010-0061.

§ 207.2 Definitions.

The definitions in Part 206 of this title are applicable to this part.

§ 207.3 Contracts made pursuant to new form leases.

On November 29, 1950 (15 FR 8585), a new lease form was adopted (Form 4-1158, 15 FR 8585) containing provisions whereby the lessee agrees that nothing in any contract or other arrangement made for the sale or disposal of oil, gas, natural gasoline, and other products of the leased land, shall be construed as modifying any of the provisions of the lease, including, but not limited to, provisions relating to gas waste, taking royalty-in-kind, and the method of computing royalties due as based on a minimum valuation and in accordance with the oil and gas valuation regulations. A contract or agreement pursuant to a lease containing such provisions may be made without obtaining prior approval of the United States as lessor, but must be retained as provided in § 207.5 of this subpart.

§ 207.4 Contracts made pursuant to old form leases.

(a) Old form leases are those containing provisions prohibiting sales or disposal of oil, gas, natural gasoline, and other products of the lease except in accordance with a contract or other arrangement approved by the Secretary of the Interior, or by the Director of the Minerals Management Service or his/her representative. A contract or agreement made pursuant to an old form lease may be made without obtaining approval if the contract or agreement contains either the substance of or is accompanied by the stipulation set forth in paragraph (b) of this section, signed by the seller (lessee or operator).

(b) The stipulation, the substance of which must be included in the contract, or be made the subject matter of a separate instrument properly identifying the leases affected thereby, is as follows:

> It is hereby understood and agreed that nothing in the written contract or in any approval thereof shall be construed as affecting any of the relations between the United States and its lessee, particularly in matters of gas waste, taking royalty in kind, and the method of computing royalties due as based on a minimum valuation and in accordance with the terms and provisions of the oil and gas valuation regulations applicable to the lands covered by said contract.

§ 207.5 Contract and sales agreement retention.

Copies of all sales contracts, posted price bulletins, etc., and copies of all agreements, other contracts, or other documents which are relevant to the valuation of production are to be maintained by the lessee and made available upon request during normal working hours to authorized MMS, State or Indian representatives, other MMS or BLM officials, auditors of the General Accounting Office, or other persons authorized to receive such documents, or shall be submitted to MMS within a reasonable period of time, as determined by MMS. Any oral sales arrangement negotiated by the lessee must be placed in written form and retained by the lessee. Records shall be retained in accordance with 30 CFR Part 212.

Subpart B—Oil, Gas, and OCS Sulfur, General [Reserved]

Subpart C—Federal and Indian Oil [Reserved]

Subpart D—Federal and Indian Gas [Reserved]

Subpart E—Solid Minerals, General [Reserved]

Subpart F—Coal [Reserved]

Subpart G—Other Solid Minerals [Reserved]

Subpart H—Geothermal Resources [Reserved]

Subpart I—OCS Sulfur [Reserved]

PART 210—FORMS AND REPORTS

1. The authority citation for Part 210 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. Part 210 is amended by revising the titles of Subparts B, C, D, F, and G to read as follows:

Subpart B—Oil, Gas, and OCS Sulfur—General

Subpart C—Federal and Indian Oil—[Reserved]

Subpart D—Federal and Indian Gas—[Reserved]

Subpart F—Coal [Reserved]

Subpart G—Other Solid Minerals [Reserved]

3. The following subparts are added to Part 210:

Subpart H—Geothermal Resources [Reserved]

Subpart I—OCS Sulfur—[Reserved]

§§ 210.100, 210.101, 210.102, 210.103, 210.104, 210.105, 210.150, 210.151 [Removed]

§§ 210.300 and 210.301 [Redesignated as §§ 210.350 and 210.351]

4. Sections 210.100, 210.101, 210.102, 210.103, 210.104 and 210.105 under Subpart C and §§ 210.150 and 210.151 under Subpart D are removed. Sections 210.300 and 210.301 under Subpart F are redesignated as new §§ 210.350 and 210.351, respectively, under new Subpart H.

5. 30 CFR Part 210, Subpart B, is amended by adding § 210.55 to read as follows:

§ 210.55 Special forms or reports.

When special forms or reports other than those referred to in the regulations in this part may be necessary, instructions for the filing of such forms or reports will be given by MMS.

PART 241—PENALTIES

1. The authority citation for Part 241 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. Part 241 is amended by revising the titles of Subparts B, C, and D to read as follows:

Subpart B—Oil, Gas, and OCS Sulfur, General

Subpart C—Federal and Indian Oil—[Reserved]

Subpart D—Federal and Indian Gas—[Reserved]

Subpart H—[Removed]

3. "Subpart H—Indian Lands—[Reserved]" is removed.

Subparts E, F, and G—[Redesignated as Subparts F, G, and H]

4. Subparts E, F, and G are redesignated as Subparts F, G, and H, respectively.

5. A new Subpart I is added to read:

Subpart I—OCS Sulfur [Reserved]

6. A new Subpart E is added to read:

Subpart E—Solid Minerals, General—[Reserved]

§ 241.10 [Removed and Reserved]

7. Section 241.10 under Subpart A is removed and reserved.

§ 241.50 [Amended]

8. Section 241.50 under Subpart B is amended by removing the phrase "this subpart" and replacing it with the phrase "Subparts B, C and D of this part."

§ 241.100 [Redesignated as § 241.53]

9. Section 241.100 under Subpart C is redesignated as a new § 241.53 under Subpart B and retitled "Assessments for nonperformance."

§ 241.53 [Amended]

10. Paragraph (c) from newly redesignated § 241.53 is removed.

TITLE 43—PUBLIC LANDS: INTERIOR

PART 3100—OIL AND GAS LEASING

1. The authority citation for Part 3100 continues to read as follows:

Authority: Minerals Leasing Act of 1920, as amended and supplemented (30 U.S.C. 181 *et seq.*), the Minerals Leasing Act for Acquired Lands, as amended (30 U.S.C. 351-359), the Alaska National Interest Lands Conservation Act (16 U.S.C. 3101 *et seq.*), Federal Land Policy and Management Act of 1976 (43 U.S.C. 1701 *et seq.*), Federal Property and Administrative Services Act of 1949 (40 U.S.C. 760 *et seq.*), the Act of May 21, 1930 (30 U.S.C. 301-306), Omnibus Budget Reconciliation Act of 1981 (Pub. L. 97-35), Department of the Interior Appropriations Act, Fiscal Year 1981 (Pub. L. 96-514), the Refuge Administration Act of 1966 (16 U.S.C. 668dd-ee), the Independent Offices Appropriation Act of 1952 (31 U.S.C. 483a) and the Attorney General's Opinion of April 2, 1941 (40 Op. Atty. Gen. 41).

§ 3103.3-1 [Amended]

2. Section 3103.3-1 is amended by removing paragraphs (c) and (d) and redesignating existing paragraph (e) as new paragraph (c).

PART 3160—ONSHORE OIL AND GAS OPERATIONS

1. The authority citation for Part 3160 continues to read as follows:

Authority: The Act of February 25, 1920 (30 U.S.C. 181 *et seq.*), as amended: the Act of May 21, 1930 (30 U.S.C. 301-306), the Mineral Leasing Act for Acquired Lands (30 U.S.C. 351-359), as amended: the Act of March 3, 1909 (25 U.S.C. 396), as amended: the Act of May 11, 1938 (25 U.S.C. 396a-396g), as amended: the Act of February 28, 1891 (25 U.S.C. 397), as amended: the Act of May 29, 1924 (25 U.S.C. 398), the Act of March 3, 1927 (25 U.S.C. 398a-398e), the Act of June 30, 1919 (25 U.S.C. 399), as amended: R.S. § 441 (43 U.S.C. 1457), see also Attorney General's Opinion of April 2, 1941 (40 Op Atty. Gen. 41), the Federal Property and Administrative Services Act of 1949 (40 U.S.C. 471 *et seq.*), as amended: the National Environmental Policy Act of 1969 (42 U.S.C. 4321 *et seq.*), as amended: the Act of December 12, 1980 (Pub. L. 96-514, 94 Stat. 2964), and the Combined Hydrocarbon Leasing Act of 1981 (Pub. L. 97-78, 95 Stat. 1070/6); the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1701), the Indian Mineral Development Act of 1982 (25 U.S.C. 2102).

2. Newly redesignated § 3162.7-4 is revised to read as follows:

§ 3162.7-4 Royalty rates on oil; sliding and step-scale leases (public land only).

Sliding- and step-scale royalties are based on the average daily production per well. The BLM authorized officer shall specify which wells on a leasehold are commercially productive, including in that category all wells, whether produced or not, for which the annual value of permissible production would be greater than the estimated reasonable annual lifting cost, but only wells that yield a commercial volume of production during at least part of the month shall be considered in ascertaining the average daily production per well. The average daily production per well for a lease is

computed on the basis of a 28-, 29-, 30-, or 31-day month (as the case may be), the number of wells on the leasehold counted as producing, and the gross production from the leasehold. The BLM authorized officer will determine which commercially productive wells shall be considered each month as producing wells for the purpose of computing royalty in accordance with the following rules, and in the authorized officer's discretion may count as producing any commercially productive well shut in for conservation purposes.

(a) For a previously producing leasehold, count as producing for every day of the month each previously producing well that produced 15 days or more during the month, and disregard wells that produced less than 15 days during the month.

(b) Wells approved by the BLM authorized officer as input wells shall be counted as producing wells for the entire month if so used 15 days or more during the month and shall be disregarded if so used less than 15 days during the month.

(c) When the initial production of a leasehold is made during the calendar month, compute royalty on the basis of producing well days.

(d) When a new well is completed for production on a previously producing leasehold and produces for 10 days or more during the calendar month in which it is brought in, count such new wells as producing every day of the month in arriving at the number of producing well days. Do not count any new well that produces for less than 10 days during the calendar month.

(e) Consider "head wells" that make their best production by intermittent pumping or flowing as producing every day of the month, provided they are regularly operated in this manner with approval of the BLM authorized officer.

(f) For previously producing leaseholds on which no wells produced for 15 days or more, compute royalty on the basis of actual producing well days.

(g) For previously producing leaseholds on which no wells were productive during the calendar month but from which oil was shipped, compute royalty at the same royalty percentage as that of the last preceding calendar month in which production and shipments were normal.

(h) Rules for special cases not subject to definition, such as those arising from averaging the production from two distinct sands or horizons when the production of one sand or horizon is relatively insignificant compared to that of the other, shall be made by the BLM authorized officer as need arises.

(i)(1) In the following summary of operations on a typical leasehold for the month of June, the wells considered for the purpose of computing royalty on the entire production of the property for the months are indicated.

Well No. and record	Count (marked X)
1. Produced full time for 30 days	X
2. Produced for 26 days; down 4 days for repairs	X
3. Produced for 28 days; down June 5, 12 hours, rods; June 14, 6 hours, engine down; June 26, 24 hours, pulling rods and tubing.	X
4. Produced for 12 days; down June 13 to 30	
5. Produced for 8 hours every day (head well)	X
6. Idle producer (not operated)	
7. New well, completed June 17; produced for 14 days.	X
8. New well, completed June 22; produced for 9 days.	

(2) In this example, there are eight wells on the leasehold, but wells No. 4, 6, and 8 are not counted in computing royalties. Wells No. 1, 2, 3, 5, and 7 are counted as producing for 30 days. The average production per well per day is determined by dividing the total production of the leasehold for the month (including the oil produced by wells 4 and 8) by 5 (the number of wells counted as producing), and dividing the quotient thus obtained by the number of days in the month.

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