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Part III

Department of the Interior

Minerals Management Service

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

43 CFR Part 3160

Revision of Oil Product Valuation Regulations and Related Topics; Further Notice of Proposed Rulemaking

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DEPARTMENT OF THE INTERIOR

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

43 CFR Part 3160

Revision of Oil Product Valuation Regulations and Related Topics

AGENCY: Minerals Management Service, Interior.

ACTION: Further notice of proposed rulemaking.

SUMMARY: Proposed valuation regulations for oil were published for comment in the Federal Register on January 15, 1987 (52 FR 1858). Public hearings were held in Denver, Colorado, on March 4, 1987, and in New Orleans, Louisiana, on March 17, 1987. Over 100 written comments were received on this proposed rulemaking.

Because of the extensive and diverse interest raised by this and related rulemakings for valuation of gas and coal, MMS established a procedure whereby it would publish draft final regulations and provide an abbreviated public comment period to obtain further public comment before the rules are issued as final regulations on September 30, 1987. The Congress is aware of and understands this process. See Conference Report on H.R. 1827 in the Congressional Record dated June 27, 1987, at pages H5661–H5666.

Accordingly, attached to this notice as an appendix is a draft of the oil valuation regulations in final form, together with a draft of the preamble for the final rule. The draft contains numerous changes from the proposed oil valuation regulations in response to the public hearings and the extensive comments received and reviewed by MMS.

DATE: Comments must be received on or before September 2, 1987.

ADDRESS: Written comments may be mailed to Minerals Management Service, Royalty Management Program, Rules and Procedures Branch, Denver Federal Center, Building 85, P.O. Box 25165, Mail Stop 628, Denver, Colorado 80225, Attention: Dennis C. Whitcomb.

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

SUPPLEMENTARY INFORMATION: The principal authors of this proposed 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); and Peter J. Schaumberg of the Office of the Solicitor, Washington, DC.

In view of the short public comment period necessitated by MMS's proposed schedule, as understood by Congress, whereby MMS will attempt to issue final rules by September 30, 1987, MMS requests that commenters not simply resubmit comments already provided on the proposed rules. All comments received since publication of the first proposed rulemaking on January 15, 1987, will be included in this rulemaking record. Additional comments should be directed to the provision of the draft final rule in the appendix. Commenters are requested to identify, by section, the provision of the draft final rule to which a comment is directed. Besides specific comments on the draft final rule, MMS also requests commenters to address whether there are additional requirements or approaches which would improve the royalty payment process. The MMS believes it has developed a set of rules which will lead to the proper payment of royalties, but given the interest and concerns raised by this rulemaking, MMS would like to learn of all approaches which will reduce underpayments and minimize any abuse in payment and collection of royalties. MMS would specifically like comments on the ability of auditors to determine compliance with these regulations. MMS also would like commenters to address the extent to which these draft rules are responsive to concerns regarding royalty underpayments identified in the Linowes Commission Report and reports of the Congress, the General Accounting Office and the Department's Office of Inspector General.

MMS recognizes that arm's-length contract prices are a principal component of these regulations. Under the draft final rules, the prices under arm's-length contracts would represent value and be the primary values under the benchmarks for non-arm's-length contracts. MMS specifically requests comments on the definition of arm's-length contract and on the use of these contracts to determine value for calculating royalty payments.

The Department of Interior (DOI) has determined that this document is not a major rule and does not require a regulatory impact analysis under Executive Order 12291. This proposed rulemaking is to consolidate Federal and Indian oil royalty valuation regulations; to clarify DOI oil royalty valuation policy and to clarify DOI oil transportation allowance policy; and to provide for consistent royalty valuation policy among all leasable minerals. Because the proposed rule principally consolidates and streamlines existing regulations for consistent application, there are no significant additional requirements or burdens placed upon small business entities.

Lessee reporting requirements will be approximately $130,000. 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.

The public is invited to participate in this proceeding by submitting data, views, or arguments with respect to this notice. All comments should be submitted by 4:30 p.m. of the day specified in the DATE section to the appropriate address indicated in the ADDRESS section of this preamble and should be identified on the outside envelope and on documents submitted with the designation "Revision of Oil Royalty Valuation Regulations and Related Topics." All comments received by the MMS will be available for public inspection in Room C406, Building 85, Denver Federal Center, Lakewood, Colorado, between the hours of 8:00 a.m. and 4:00 p.m., Monday through Friday.

Any information or data submitted which is considered to be confidential must be so identified and submitted in writing, one copy only. MMS reserves the right to determine the confidential status of the information or data and to treat it according to its independent determination.

Regulatory Flexibility Act

Because this rule primarily consolidates and streamlines existing regulations for consistent application, there are no significant additional requirements or burdens placed upon small business entities as a result of implementation of this proposed rule. Therefore, the DOI has determined that this rulemaking will not have a significant economic effect on a substantial number of small entities and does not require a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. 601, *et seq.*).

Paperwork Reduction Act of 1980

The information collection and

recordkeeping requirements located at §§ 206.105, 207.5, and 210.55 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

Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 203

Coal, Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources.

30 CFR Part 206

Continental shelf, Geothermal energy, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources.

30 CFR Part 207

Government contracts, Mineral royalties, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 210

Continental shelf, Geothermal energy, Government contracts, mineral royalties, Oil and gas exploration, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 241

Administrative practice and procedures, Government contracts, Mineral royalties, Oil and gas exploration, Penalties, Public lands—mineral resources, Reporting and recordkeeping requirements.

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.

Dated: August 10, 1987.

James E. Cason,

Acting Assistant Secretary, Land and Minerals Management.

Appendix—Draft Final Rule

DEPARTMENT OF THE INTERIOR

Minerals Management Service

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

43 CFR Part 3160

Revision of Oil Product Valuation Regulations and Related Topics

Agency: Minerals Management Service, Interior.

Action: [Draft] 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: November 1, 1987 (tentative).

For further information contact: Dennis C. Whitcomb, Chief, Rules and Procedures Branch, (303) 231-3432, (FTS) 326-3432.

Supplementary information: The principal authors of this rulemaking are John L. Price, Scott L. Ellis, Thomas J. Blair, Stanley J. Brown, and William H. Feldmiller, of the Royalty Valuation and Standards Division of the Royalty Management Program, Minerals Management Service (MMS); 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 these hearings.

[Tentative: Because of the complexity of the regulations, and in accordance with MMS's understanding with Congress, MMS issued a further notice of proposed rulemaking 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. A total of_____ additional comments were received.]

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. A complete account of that 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 Part 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 and redesignation of Parts 202, 203, 206, 207, and 210. 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, §§ 202.51, 202.102, 206.103, 206.104, 207.1, 207.2, 207.5, and 210.55 are added to the appropriate subparts.

Current § 206.104, proposed as § 202.101, 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.

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. Subparts E, F, and G of Part 241 are redesignated as Subparts F, G, and H, respectively.	This administrative action permits the insertion of a new Subpart E—"Solid Minerals, General" in this Part.
2. Sections 202.150, 202.151, and 202.152 are redesignated as §§ 202.100, 202.53, and 202.52, respectively. Section 203.150 is redesignated as § 203.50.	This administrative action more appropriately locates within 30 CFR the information contained in these sections.
Section 206.104 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.
3. Sections 210.300 and 210.301 are redesignated as §§ 210.350 and 210.351, respectively.	This action corresponds to the redesignation of Subpart G as Subpart H (see Item 1, above).
4. Section 241.100 is redesignated as § 241.60	This action is the result of retitling of the subparts.
II. DELETIONS:	
1. Subpart H—"Indian Lands" is removed from Part 241	Oil royalty valuation for Indian Lands is now covered by Subpart C—Federal and Indian Oil.
2. Sections 202.100 through 202.103 are removed from Subpart B of Part 202.	These sections cover activities now governed by BLM.
3. Section 203.100 is removed from Subpart C	This section covers an activity now governed by BLM operations personnel.
4. Section 206.103 is removed from Subpart C of Part 206	This section has been rewritten and relocated in the regulations as Subparts C and D of Part 206.
5. Sections 207.1, 207.2, 207.5, 207.6 and 207.7 are removed from Subpart A of Part 207.	The subject matter of these Sections is addressed elsewhere in the regulations. They are, therefore, redundant and have been removed to avoid confusion.
6. Sections 210.100 through 210.105, §§ 210.150 and 210.151 are removed from Subpart C and D, respectively, of Part 210.	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). § 210.105 has been replaced by new § 210.55.
7. Section 241.100 is redesignated as § 241.60. Paragraph 241.60(c) is removed from Subpart C of Part 241.	Newly redesignated § 241.60(c)(1) is no longer applicable (this form is no longer in use).
III. ADDITIONS:	
1. The following subparts are added to Part 207:	
Subpart A—General Provisions	Separate subparts have been added to Part 207 to make it consistent with other parts of 30 CFR Chapter II and to provide both structure and space for future expansion of this portion of the regulations.
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]	
2. The following subparts are added to Part 210:	
Subpart H—Geothermal Resources [Reserved]	These new subparts provide space for regulations of general applicability to geothermal resources and OCS sulfur.
Subpart I—OCS Sulfur [Reserved]	
3. The following subparts are added to Part 241:	
Subpart E—Solid Minerals, General [Reserved]	These new subparts provide space for future regulations of general applicability to solid minerals and OCS sulfur.
Subpart I—OCS Sulfur [Reserved]	
4. Sections 202.51 and 202.101 are added to Part 202. Sections 206.103 and 206.104 are added to Part 206.	These new sections provide oil valuation standards and procedures.
5. Sections 207.1, 207.2, and 207.5 are added to Part 207	These new sections reference the definitions in Part 206 and set forth certain recordkeeping requirements.
6. Section 210.55 is added to Part 210	This will replace § 210.105.
IV. AMENDMENTS:	
1. Parts 202, 203, 206, 210, and 241 are amended by retitling the following Subparts:	
Subpart B retitled "Oil, Gas, and OCS Sulfur, General	These subparts have been retitled in order to organize them by a commodity (oil vs. gas, etc.) rather than emphasizing location (onshore vs. offshore) as was done formerly.
Subpart C retitled "Federal and Indian Oil [Reserved]"	
Subpart D retitled "Federal and Indian Gas [Reserved]"	

The rules in § 206.100 expressly recognize that where the provisions of any Indian lease, or any statute or treaty affecting Indian leases, are inconsistent with the regulations, then the lease, 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 those 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). The public comment period on the proposal closed on April 15, 1987. Over one hundred commenters provided extensive comments which were received and considered in preparing this notice.

Of the 57 commenters filing comments on valuation issues, 30 commenters represented industry/trade groups; 15 represented State, local, and Federal governmental entities; 10 represented Indian Tribes or allottees; 1 commenter was a State/Tribal association and 1 commenter was an individual. Of the 46 commenters filing comments on transportation issues, 24 commenters represented industry/trade groups; 8 represented State, local, and Federal governmental entities; 11 represented Indian Tribes or allottees; 1 commenter was a State/Tribal association; and 2 commenters were individuals.

General Comments

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 (representing eight respondents) on one side of this issue and States and Indians (representing six respondents each) on opposing sides. 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 Purposes

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 this vein, two State and three 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, one Indian and two State commenters suggested that reported gross proceeds values should be tested/validated by using the net-back (work-back) procedure as an independent cross-check. They also suggested that royalty reporting should be routinely monitored by using this procedure.

MMS Response: 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. The performance of labor intensive net-back calculations on a routine basis is impractical.

Two 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 (two) and Indians (two) 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

Three State and three 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 Leasing Act, FOGRMA, and the valuation procedures being adopted herein.

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 (two State, one Indian, and one Federal bureau) believed 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

One State and four 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 economic 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.

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.

Two 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.

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, and, thus, is outside the scope of this rulemaking.

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.

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. The same commenter recommended inserting "from the lease site" in paragraph (b) to assure conformity with the specific requirements of FOGRMA, 30 U.S.C. 1756. MMS has adopted this change.

Section 202.100(c) was proposed as § 206.100(d). The only comment received was 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 addition of the recommended phrase, therefore, is considered inappropriate for inclusion in this rulemaking.

MMS has added at § 202.100(d) of the final rules a provision concerning production governed by a federally approved unitization or communitization agreement. Section 202.100(d) 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. Most important, however, § 202.100(d) requires 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. By way of illustration, 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 one of the 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.

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 subsection, 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.

In accordance with paragraph (b) of this section, where the provisions of any statute, treaty, or lease are inconsistent with these regulations, the lease, statute, or treaty 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 statue 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."

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.

Only two 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.

Proposed § 206.100(e) would have required royalties to be paid on

insurance compensation for unavoidably lost oil. Of the nine comments received concerning this section, eight from industry objected to MMS's concept of value. Their rationale can be summarized as follows: "Royalty is due on production saved, removed, or sold, and insurance proceeds for production unavoidably lost does not fit into any of those categories and is not a royalty assessable event. Because MMS does not share in the expense for insurance coverage, it should not receive any royalty or compensation received as a result of such coverage."

One of these comments expands on this argument by stressing that "if MMS *insists on collecting a portion of* such proceeds, then to the extent that insurance may cover the royalty interest of unavoidably lost production, proceeds should be shared only if the cost of insurance coverage is recognized as an allowable royalty deduction."

MMS Response: Pursuant to § 202.100(b) of the final rules, no royalty is due on production which is unavoidably lost. Therefore, MMS has concluded that no royalty is due on any insurance compensation for such production.

Section 206.101 Definitions.

Allowance—A total of four comments were received on this paragraph; two were from State entities, one from an Indian Tribe, and one from 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.

Area—A single 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 total of 41 comments were received on this definition—27 from industry, 4 from Indians, 1 from a State/Tribal association, 8 from States, and 1 from 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 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." Six 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's-length 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. 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 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

[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.

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."

MMS Response: Based on the numerous comments concerning the "restrictive" nature of the definition and the soundness of the arguments, MMS has decided to modify the phrase "* * * or if one person owns an interest (regardless of how small), either directly or indirectly, in another person" with the "control" language found in the BLM's regulations at 43 CFR 3400.0-5(rr)(3).

Furthermore, MMS recognizes that for the purposes of determining whether a contract is arm's-length or non-arm's-length (e.g., affiliated), the test of affiliation must be derived contract-by-contract. This means that, for example, two companies may be involved as 60-40 partners in a joint venture to acquire and develop an OCS lease. If the company with the 60-percent interest buys the production from the joint venture company, that contract will be non-arm's-length. However, the two companies who formed the joint venture still may be considered by MMS to have an arm's-length sales contract between them for production from another lease, provided the 20-percent ownership threshold is not exceeded. In the event that one company does own a 20-percent, or greater, interest in the other, then MMS would presume that any transaction between them is non-arm's-length.

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.

The very nature of an arm's-length contract implies an adverse economic interest between the contracting parties. The MMS believes that the intent of the final definition (which includes the BLM "control" language) satisfies the concerns of those commenters who felt that the definition should include specific "adverse economic interest" language. Moreover, MMS has included in the final rule 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 agree 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 will not treat that contract as arm's-length. MMS does recognize, however, that two parties may have a course of dealing so that some may argue that any contract between them could be construed as including some consideration other than the specified price. It is not MMS's intention to exclude such bona fide agreements from the definition of arm's-length contract.

This definition in no way limits the Secretary's authority to question or "look behind" an arm's-length agreement if there is reason to suspect that elements of the agreement are less than arm's-length.

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—Only one industry comment was received on this proposed definition. This 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 single comment was received on this proposed definition. Although this State commenter recognized that "as a matter of law, oral contracts are enforceable," they recommend 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 has included in the 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.

Gross Proceeds—Twenty-eight respondents commented on the definition of "gross proceeds"—22 from industry, 4 from states, 1 from an Indian tribe, and 1 from a State/tribal association. Of the 28, 2 endorsed the proposed definition as published, 2 recommended changes to clarify or expand the scope of the definition, and 24 objected to it for various reasons. The main objection was that the definition appears to include consideration unrelated to the value of production.

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. Additionally, 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."

MMS Response: MMS has adopted a definition which is modified slightly from that proposal for purposes of clarification. MMS has 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.

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 (with a few exceptions addressed later in this preamble) 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—Only one Indian respondent commented on this definition. The comment 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 13 different respondents—12 from industry and 1 from a State. 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 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.

The 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.

Load Oil—Two comments were received on this proposed definition—one from a State and one from industry. The 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."

The 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—Three respondents commented on this definition— one from industry, one from a Federal agency, and one from a State. The 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."

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)(1).)

Net-back method—One industry respondent and two State respondents commented on the proposed definition. The two States objected to the proposed definition and the 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 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 three 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. MMS has revised the definition so it more clearly applies to this type of situation.

Person—The MMS received a total of four comments on this definition. 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.

MMS Response: Because the definition of arm's-length contract has been modified to include the BLM "control" language, most of the comments on this definition no longer are relevant. Therefore, MMS will retain the proposed definition of "person" intact in the final rule.

Posted price—The proposed definition received four 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."

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.

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 both transportation allowances and the limited allowances provided by § 206.102(i)(2) of the final rule. 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 generally will be based upon the higher of those two values. However, if MMS determines that the major portion results in an unreasonably high value, then it will not be used for royalty purposes. This could happen, for example, in a falling market where a seller under an arm's-length contract has the price lowered. If that price is truly the result of an arm's-length process and is lower than the major portion, MMS could conclude that the arm's-length price is the highest reasonable value for royalty purposes.

The MMS is also including in paragraph (2) a description of how the major portion is computed. It will be determined using like-quality oil. 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.

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 generally using the higher of the two, the Indians will be receiving royalties in accordance with their contract with the lessee.

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.

Seven State, seven Indian, 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. These 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 producer'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 confine 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: The purpose of these regulations is to determine the reasonable market value of a commodity and use that value for royalty computation purposes. The market value is best determined from the interaction of competing market forces, and an arm's-length contract price is the product of market forces at work. Accordingly, MMS will generally accept the gross proceeds received under an arm's-length contract as the proper value for royalty computation purposes. The usual lease provisions do not preclude the acceptance of gross proceeds under an arm's-length contract as the proper value. In fact, most Indian leases expressly provide that the lessee's proceeds may be considered by the Secretary to be conclusive evidence of the value of production. As discussed above, for many Indian leases, MMS will also consider the major portion in determining the royalty value.

The MMS has added a provision to the final rule which provides that MMS will determine during audits whether the lessee's contract reflects all the consideration transferred either directly or indirectly from the buyer to the seller for the oil, or whether there may be factors which would cause the contract not to be arm's-length. MMS recognizes that some parties may have multiple contracts with one another. This fact alone would not cause a contract to be considered non-arm's-length. Rather, there must be some indication that the contract in question does not reflect the full agreement between the parties.

The MMS also has added a new § 206.102(b)(2) which provides that 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 for the oil.

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 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 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. 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 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.

Eleven industry, one Federal agency, and one individual commenter 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 or the lease agreement requires a different value. 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.

Seven States, eight 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."

MMS Response: The MMS believes that the proposed 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 cases, 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 cases 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.

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's-length 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 cases 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 a § 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. In effect, 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 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 Secretarys 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.

Three industry and two 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.

Fourteen industry commenters, one Federal agency, and one 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.

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. It 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 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).

Most of the 16 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.

Section 206.102(f) was proposed as paragraph (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: At this time MMS has no legal authority to pay interest on royalty overpayments.

Section 206.102(g) was proposed as paragraph (f), and prescribes a procedure for a lessee to request a value determination from MMS. It has been adopted as it was proposed with some minor modifications. Three industry commenters suggested that there be a time limit of 120 days for MMS valuation responses. One 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 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 paragraph (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. Eight 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.

Two 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 type of allowance, not just transportation allowances. As explained below, MMS has adopted a rule which would provide for deduction of certain extraordinary costs.

Three 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 states 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 event no further transportation allowance would be authorized).

Section 206.102(i) was proposed as paragraph (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.

MMS Response: Historically, MMS's policy and practice is that the lessee generally 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. However, MMS has considered carefully all of the comments on this issue and decided that there may be certain circumstances where some extraordinary costs for gathering, desulfurization or storage should be allowed as a deduction. Such allowances will be authorized on *individual cases* only upon application to the MMS. A new § 206.102(i)(2) has been added which establishes a two-part test for qualification for a cost allowance. First, only production from leases in unusually high-cost or frontier areas qualify. The only leases that qualify are those located north of the Arctic Circle or those OCS leases located in water depths in excess of 400 meters. Any leases that do not meet this first test cannot apply for this allowance. However, even for leases that meet this test, MMS will not grant an allowance unless the lessee demonstrates to MMS's satisfaction that the costs are, by reference to standard industry conditions and practice, deemed to be extraordinary, unusual, or unconventional. In some instances, MMS may grant an allowance only to the extent that the extraordinary costs exceed conventional costs for the same operation.

Section 206.102(j) was proposed as paragraph (i). There were 13 commenters on this section—10 industry, 2 State, and 1 Indian. 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. One State and four 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.

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 he/she 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(1) was proposed as paragraph (j). Comments were received from three States 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 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.

Section 206.103 Point of royalty settlement.

Twelve industry representatives and two States commented on this section. The two 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.

Ten 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 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 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 as it was fully addressed in the discussion of § 206.102(l). 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. 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 royalty-in-kind oil. Eight industry commenters stated that MMS should grant a transportation allowance for onshore royalty-in-kind oil. Another industry commenter suggested that the regulations should clearly state that the lessee is not required to transport royalty-in-kind oil from the lease. Three industry commenters stated that this subsection was in conflict with section 208.8 of the proposed RIK regulations.

MMS Response: The suggestion that MMS should grant a transportation allowance for onshore royalty-in-kind 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 royalty-in-kind 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. Four 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 33 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.

Seventeen 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."

Twelve 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.

Twelve industry and one State commenter 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.

Eight 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.

Two State, one State/Tribal association, and one industry commenter 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.

The MMS received a total of seven 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.

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 nonroyalty-bearing substances should have a transportation allowance. 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. Accordingly, MMS has retained the cost allocation on the basis of relative-volume in the regulations. Section 206.104(d) has been retained in the final rule in the same form as proposed.

Section 206.105 Determination of transportation allowances.

The MMS received 28 separate comments on these regulations.

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.

Five industry commenters responded that the oil transportation allowance regulations should be written to support the use of FERC-101 approved tariffs and arm's-length transportation agreements as an accurate indicator of reasonable, actual costs.

Two 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. However, 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. MMS is creating a limited exception to this

policy, discussed below, in regard to § 206.105(b).

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 14 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.

Fourteen 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.

Six 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.

One State and one Indian commenter 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 pre-approve 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.

Six 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.

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.

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 at the time these regulations become effective will be allowed to continue until they terminate, subject to audit.

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

Seven 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 filing of Form MMS-4110 on an annual basis 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?*

One 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: It has never been MMS's policy to permit transportation allowances for production which is not royalty bearing. Historically, MMS's policy and practice has been to limit transportation allowance deductions only to the royalty-bearing portion of lease production transported.

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 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 determined that allocating costs on the basis of relative volume rather than on the basis of relative value is more equitable because of the wide variance in relative value between some products. The MMS will allow the lessee to propose an allocation procedure. 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.

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.

The MMS received comments from 26 commenters on § 206.105(b) which applies to non-arm's-length or no contract transportation situations—17 from industry, 6 from industry trade groups, 1 from a State association, 1 from an Indian Tribe, and 1 from 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?

Thirteen 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: The MMS has reviewed the FERC procedure for granting tariffs. After careful consideration, MMS has decided that in most instances, 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. The MMS will recognize FERC tariffs as a valid cost in computing a transportation allowance only when it is an actual out-of-pocket expense pursuant to an arm's-length transportation contract. Existence of a FERC-approved tariff for a transportation system, however, is one of the requisite criteria for MMS to consider in granting an exception to the requirement to use actual costs for non-arm's-length or no contract situations. See discussion below.

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

Nine 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 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, 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 a 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 a limited exception to the requirement to use costs where the lessor's interest is adequately protected. The lessee must apply to the MMS for an exception from the requirement that it compute actual costs. The MMS may grant the exception only if: (1) The lessee has arm's-length contracts with other persons for transportation through the same transportation system; (2) the lessee has a FERC-approved tariff for the system; and (3) the persons purchasing transportation services from the lessee had a reasonable alternative to using the lessee's system (thus ensuring that the transportation contract price was not arrived at because the person requiring transportation had no choice but to accept the lessee's price). If the MMS grants the exception, then the lessee will use as its transportation allowance the volume-weighted average of the prices it charges other persons pursuant to arm's-length contracts.

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

Twenty-five 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?

One 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 shall 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 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 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 a calendar year basis has been considered and the regulations at § 206.105(c) have been revised to provide for calendar-year reporting.

6. Should MMS require prior approval for allowances?

Two 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?

Four 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?

Nineteen 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.

Five 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 rate of return used by FERC was not considered because MMS does not believe that the FERC's obligations in developing tariffs and those of MMS in developing transportation allowances are sufficiently similar to warrant the use of similar procedures.

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, MMS intends in the near future to 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?

Four 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.

Four 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.

Six 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.

Two 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).

Two 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.

Five 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.

One 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 for the depreciation of a system only once.

The MMS has carefully considered the issue of basing the rate of return on the basis of 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.

The MMS received 19 comments from industry and 2 comments from 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?

Six industry and one Indian commenter 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.

Five 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 whether 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 effectively monitor the transportation allowance deductions without 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.

Four 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. 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. 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.

Nine 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.

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

One 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.

Four 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.

The MMS received 17 industry comments on § 206.105(f), which was proposed as paragraph (e). All 17 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. Five 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 due to 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. No change to the final rule was made.

Four comments were received on § 206.105(g), which was proposed as paragraph (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-bas[illegible] 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 net-back procedure.

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 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, 207.4, and 210.55 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

Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 203

Coal, Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources.

30 CFR Part 206

Continental shelf, Geothermal energy, Government contracts, Mineral royalties, Oil and gas exploration, Public lands—mineral resources.

30 CFR Part 207

Government contracts, Mineral royalties, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 210

Continental shelf, Geothermal energy, Government contracts, mineral royalties, Oil and gas exploration, Public lands—mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 241

Administrative practice and procedure, Government contracts, Mineral royalties, Oil and gas exploration, Penalties, Public lands—mineral resources, Reporting and recordkeeping requirements.

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: __________

____

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 Part 3160 are amended as follows:

TITLE 30—MINERAL RESOURCES

CHAPTER II—MINERALS MANAGEMENT SERVICE, DEPARTMENT OF THE INTERIOR

Subchapter A—Royalty Management

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. 30 CFR Part 202 is amended by revising the part title and the titles of Subparts B, C, and D 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]

§§ 202.100 through 202.103 [Removed]

3. Sections 202.100, 202.101, 202.102 and 202.103 under Subpart C are removed.

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

Subpart D (§§ 202.150 through 202.151) [Reserved]

Sections 202.150, 202.151 and 202.152 under Subpart D are redesignated as new § 202.100 under Subpart C and §§ 202.53 and 202.52 under Subpart B, respectively, and Subpart D is reserved.

4. In Subpart B, add new § 202.51 and revise §§ 202.52 and 202.53 (formerly §§ 202.152 and 202.151, respectively) 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 Sulfur, General

§ 202.51 Scope and definitions.

(a) This part 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.

5. 30 CFR Part 202, Subpart C, is amended by revising newly redesignated § 202.100 (formerly § 202.150) and by adding § 202.101 to read as follows:

Subpart C—Federal and Indian Oil

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

§ 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 multiplied by the royalty rate in the lease.

(b) All oil (except oil unavoidably lost from the lease site 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 appropriate agency) produced from a Federal or Indian lease to which this Part applies is subject to royalty. 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 Part 206.

(d) 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. The value for royalty purposes of that production will be determined in accordance with Part 206. In applying the requirements of Part 206, the circumstances involved in the actual disposition of the portion of the production to which the lessee was entitled but did not take shall be considered as controlling in arriving at the value for royalty purposes of that portion as if the person actually selling or disposing of the production were the lessee of the Federal or Indian lease.

§ 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. 30 CFR Part 203 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]

§ 203.100 [Removed]

3. Section § 203.100 under Subpart C is removed.

§ 203.150 [Redesignated as § 203.50]

Subparts C and D [Reserved]

Section 203.150 under Subpart D is redesignated as § 203.50 under Subpart B, and Subparts C and D are reserved.

PART 206—PRODUCT VALUATION

1. The authority citation for Part 206 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. 30 CFR Part 206 is amended by revising the titles of Subparts B, C, and D 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]

§§ 206.103 and 206.104 [Removed]

3. Sections 206.103 and 206.104 are removed.

4. 30 CFR Part 206, 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).

(b) If the specific provisions of any statute, treaty, or oil and gas lease subject to the requirements of this Part are inconsistent with any regulation in this Part, then the statute, treaty, or lease provision 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 part are intended to ensure that any 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 part (and Parts 202, 203, 207, 210, and 241 of this chapter):

"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 between independent, nonaffiliated persons which reflects the total consideration actually transferred directly or indirectly from the buyer to the seller for the oil. 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 section, 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 20 through 50 percent creates a presumption of control; and

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

Notwithstanding any other provisions of this section, 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 paid 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, 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.

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

"Net-back method" (or work-back method) means a method for calculating market value of oil at the lease when value cannot be calculated on the basis of oil of comparable value. Under this method costs of transportation, processing or manufacturing are deducted from the ultimate proceeds received for the oil and any extracted, processed, or manufactured 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 (i.e., fossilized, insoluble, organic material) bearing rock. 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.

"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 require a cancellation notice to terminate, and which does not normally 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, 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 (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 for royalty purposes shall be the higher of those two values unless MMS determines that the value for royalty purposes determined in accordance with the other provisions of this section is the highest reasonable royalty value.

(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 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) The value of oil which is sold pursuant to an arm's-length contract shall be the gross proceeds accruing to the lessee. The value which the lessee reports for royalty purposes is subject to monitoring, review, and audit. In conducting these reviews and audits, MMS will determine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the oil, or whether there may be factors which would cause the contract not to be arm's-length. The MMS may direct a lessee to pay royalty based upon a different value if it determines that the lessee's reported value is inconsistent with the requirements of these regulations.

(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 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 area; 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 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 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) If an appropriate value cannot be determined using paragraphs (c)(1) through (4), a net-back method or any other reasonable method to determine value may be used; and

(6) For purposes of this subsection, 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, or to the Office of the Inspector General of the Department of the Interior, the General Accounting Office 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)(l) 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 § 206.102(c)(4) or (5). 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 section is a one-time notification due no later than the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by § 206.102(c) (4) or (5) 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 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. 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 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)(l) 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.

(2) If the lessee incurs extraordinary costs for the gathering, desulfurization or storage of oil from frontier or deep water areas and those costs relate to unusual or unconventional operations, it may apply to MMS for an allowance. Such an allowance maybe granted only if:

(i) The costs are associated with leases located north of the Arctic Circle, or the costs are associated with offshore leases located in water depths in excess of 400 meters; and

(ii) The lessee can demonstrate that the costs are, by reference to standard industry conditions and practice, extraordinary, unusual, or unconventional.

(3) The MMS shall determine the amount of the extraordinary cost allowance which shall remain in effect for the period specified in the approval, not to exceed 1 year. To retain the authority to deduct the allowance, the lessee must report the deduction to MMS at the end of the approval period, and annually thereafter, in a form and manner prescribed by MMS. MMS annually shall reconsider whether a unique production operation will continue to be eligible for an extraordinary cost allowance determined in accordance with this subsection. Extraordinary cost allowance deductions are subject to monitoring, review, audit. and adjustment.

(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 regulation 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.

(1) 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, may 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 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 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; or

(2) Transport oil from an offshore lease to the point off the lease; provided, however, that for oil taken as royalty in kind, 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 royalty in kind oil purchaser and the Federal Government.

(b)(1) Except as provided in paragraph (b)(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. 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. However, no transportation deduction shall be allowed for products which are not royalty bearing. 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) 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, subject to monitoring, review, audit, and adjustment. 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, 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.

(2) 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 (including water) to the volume of all liquid products. No allowance may be taken for the costs of transporting lease production which is not royalty bearing.

(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 [*insert the last day of the month which is 3 months after the last day of the month of the effective date of these regulations*] 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. No allowance may be taken for the costs of transporting lease production which is not royalty bearing.

(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. No additional transportation allowance will be granted in such circumstances.

(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 subsection. All transportation allowances deducted under a non-arm's-length or no contract situation are subject to monitoring, review, audit, and adjustment. Before any estimated or actual deduction may be taken, the lessee must submit a completed Form MMS-4110 in its entirety in accordance with § 206.105(c)(2). 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-arm's-length or no contract situations shall be based upon the lessee's actual costs for transportation during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial capital investment in the transportation system multiplied by the rate of return (determined pursuant to paragraph (b)(2)(v) of this section) 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 (paragraph (b)(2)(iv)(A) of this section) or a return on depreciable capital investment (paragraph (b)(2)(iv)(B) of this section). Once a lessee has elected to use either (A) or (B) 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 [*enter the effective date of these regulations*].

(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 § 206.105(c)(2)).

(3) The deduction for transportation costs shall be determined based on 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 (including water) to the volume of all liquid products and such allocation shall be made in a consistent and equitable manner. The lessee may not take an allowance for transporting lease production which is not royalty bearing.

(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 [*insert the last day of the month which is 3 months after the last day of the month of the effective date of these regulations*] or within 3 months after the last day of the month for which the lessee reques‸ 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. The lessee may not take an allowance for transporting a product which is not royalty bearing.

(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 may grant the exception only if:

(i) The lessee has arm's-length contracts for transportation of other production through the same transportation system;

(ii) The lessee has a tariff for the transportation system approved by the Federal Energy Regulatory Commission; and

(iii) The persons purchasing transportation services from the lessee had a reasonable alternative to using the lessee's transportation system.

If the MMS grants the exception, the lessee shall use as its transportation allowance the volume-weighted average prices it charges other persons pursuant to arm's-length contracts for transportation through the same transportation system.

(c) *Reporting requirements*—(1) *Arm's-length contracts.* (i) With the exception of those transportation allowances specified in paragraph (c)(1)(v) of this section, the lessee shall submit page one of the initial Form MMS-4110, 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.

(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 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. Lessees may request special reporting procedures in unique allowance reporting situations, such as those that relate to spot sales.

(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.

(2) *Non-arm's-length or no contract.* (i) With the exception of transportation allowances specified in paragraph (c)(2)(v) 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. 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 which 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.

(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 based transportation allowances which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate.

(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.

(3) The MMS may establish reporting dates for individual lessees different than those specified in this subpart in order to provide more effective administration. Lessees will be notified as to 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 MMS-2014 to reflect actual costs together with its payment, in accordance with instructions provided by MMS. If the lessee's estimated costs were less than its actual costs, the refund procedure will be specified by MMS.

(f) 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.

(g) *Other transportation cost determinations.* The provisions of this section shall apply to determine transportation costs when establishing value using a net-back valuation procedure or any other procedure that requires deduction of transportation costs.

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.

Sec.
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: 30 U.S.C. 181 *et seq.*; 30 U.S.C. 351 *et seq.*; 30 U.S.C. 1001 *et seq.*; and 30 U.S.C. 1701 *et seq.*

Subpart A—General Provisions

§ 207.1 Required recordkeeping.

The recordkeeping requirements contained in Part 207 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 form of lease 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.

§ 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 either contains 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.

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. 30 CFR Part 210 is amended by revising the titles of Subparts B, C, D, E, 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 through 210.105, 210.150 and 210.151 [Removed]

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.

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

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 the 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. 30 CFR 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, 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 is removed and reserved.

§ 241.50 [Amended]

8. Section 241.50 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 § 241.60 and amended]

Subpart C (§ 241.100)—[Reserved]

9. Section 241.100 under Subpart C is redesignated as a new § 241.60 under Subpart B and retitled "Assessments for nonperformance" and Subpart C is reserved.

§ 241.60 (New) [Amended]

10. Paragraph (c) from newly redesignated § 241.60 is removed.

TITLE 43—PUBLIC LANDS: INTERIOR

CHAPTER II—BUREAU OF LAND MANAGEMENT, DEPARTMENT OF THE INTERIOR

PART 3160—ONSHORE OIL AND GAS OPERATIONS—GENERAL

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

Authority: The Mineral Leasing Act, as amended and supplemented (30 U.S.C. 181 *et seq.*), the Act of May 21, 1930 (30 U.S.C. 301-306), the Mineral Leasing Act for Acquired Lands, as amended (30 U.S.C. 351-359), the Act of March 3, 1909, as amended (25 U.S.C. 396), the Act of May 11, 1938, as amended (25 U.S.C. 396a-396q), the Act of February 28, 1891, as amended (25 U.S.C. 397), 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, as amended (25 U.S.C. 399), R.S. section 441 (43 U.S.C. 1457), the Attorney General's Opinion of April 2, 1941 (40 Op Atty. Gen. 41), the Federal Property and Administrative Services Act of 1949, as amended (40 U.S.C. 471 *et seq.*), the National Environmental Policy Act of 1969, as amended (42 U.S.C. 4321 *et seq.*), the Act of December 12, 1980 (94 Stat. 2964), the Combined Hydrocarbon Leasing Act of 1981 (95 Stat. 1070), 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).

§ 3162.7-4 [Redesignated as § 3162.7-5]

2. Section 3162.7-4 is redesignated as a new § 3162.7-5 and a new § 3162.7-4 is added 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 29 days; down June 6, 12 hours, rods; June 14, 6 hours, engine down; June 28, 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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