



United States Department of the Interior



MINERALS MANAGEMENT SERVICE
Minerals Revenue Management
P.O. Box 25165
Denver, Colorado 80225-0165
www.mrm.mms.gov

OCT 7 2009

RE: GUIDANCE ON VALUING GAS FOR ROYALTY PURPOSES –
MANZANARES GAS SYSTEM, SAN JUAN BASIN, NEW MEXICO

Dear Reporter:

The Minerals Management Service (MMS) is providing the information below in response to several requests for guidance in situations where Federal royalty payors deduct transportation allowances from their royalty obligations for gas produced from Federal oil and gas leases. Williams Four Corners LLC (Williams) gathers, compresses, dehydrates, and treats gas via the Manzanares Gas System (MGS) and charges a bundled fee for these services. Williams does not identify which charges are allowed or not allowed as deductions from Federal royalties. This guidance provides a method to determine a percentage of these fees that MMS believes are deductible as transportation costs, rather than non-deductible marketable condition costs. This letter does not apply to you if your company is not currently transporting production through the MGS.

The MMS' regulations at 30 CFR § 206.151 (2008) define "marketable condition" as "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." Those same regulations define a "transportation allowance" as "an allowance for the reasonable, actual costs of moving unprocessed gas, residue gas, or gas plant products to a point of sale or delivery off the lease, unit area, or communitized area, or away from a processing plant. The transportation allowance does not include gathering costs."

Non-deductible marketable condition costs under these definitions are interpreted to include the costs of compression and dehydration incurred after the gas leaves the Bureau of Land Management approved royalty measurement point to meet the requirements of the pipelines that serve the market into which the gas is typically sold. Once gas reaches marketable condition, if such services are required for transportation and exceed the services necessary to place the gas into marketable condition, the costs of further compression and dehydration are considered as transportation costs and allowed as a transportation allowance.

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To allocate costs that MMS considers allowable as a transportation deduction and those not deductible because they are costs associated with placing production into marketable condition, MMS followed the same methodology as that affirmed by the decision in *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008). The MGS design contains more than 150 compression and dehydration units which bring the gas stream to marketable condition. The current design contains 11 compressors located after the gas reaches marketable condition and are necessary to transport gas to the end point of the MGS at the Milagro treatment plant. The costs associated with these 11 compressors are considered allowable costs for Federal transportation allowance purposes. The allowable transportation costs also include pipelines, overhead, and other costs, and the allowable costs for the fuel used by the compressors.

After determining the services that MMS considers as transportation, MMS performed a cost study of the MGS. The MMS then allocated those costs between equipment associated with deductible transportation costs, and equipment associated with non-deductible marketable condition costs, to derive the annual percentage of transportation and fuel costs that are allowable transportation deductions from Federal royalties (Annual Factors). The MMS will continue to track the Annual Factors from 2008 forward. The MMS will notify you when the Annual Factors change so you may update your transportation allowance deductions.

The Enclosure provides the Annual Factors and an example of how to apply the Annual Factors to your transportation costs with:

Part 1 presenting an allocation method where the bundled fees charged by the system operator are segregated into the allowable transportation deduction; and

Part 2 presenting an allocation method where the value of fuel used is determined in the transportation deduction.

The results of the transportation deductions calculated in the Enclosure from Part 1 and Part 2 are added together. The resulting value, a transportation allowance deduction, is subject to MMS regulations at 30 CFR § 206.156 (c).

This letter does not require that you perform any type of restructured accounting or require that you recalculate and pay royalties. It is merely guidance on how transportation allowances can be determined on the MGS. The guidance provided in this letter is not an appealable decision or order under 30 CFR Part 290 Subpart B. If MMS issues you an order at a later date based on this guidance, your appeal rights will be provided at that time.

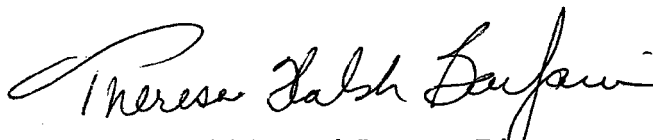
Please note that the citations to regulations are for the current versions. If these change, please use the most recent applicable version. If you have questions regarding a specific situation involving movement of your gas production through the MGS, please request valuation and reporting advice from Audit and Compliance Management under 30 CFR § 206.152(g). Please send your request to:

Theresa Walsh Bayani
Minerals Management Service
P.O. Box 25165
MS 62200B
Denver, CO 80225-0165

FAX: (303) 231-3744

If you have any questions concerning this letter, please call Mr. James Morris at 1-800-634-6423 or (303) 231-3770.

Sincerely,

A handwritten signature in black ink that reads "Theresa Walsh Bayani". The signature is written in a cursive style with a large initial 'T' and a long, sweeping underline.

Theresa Walsh Bayani, Program Director
Audit and Compliance Management

Enclosure

Part 1

Deductible Amount of Transportation Costs

		Annual Factor:						
		2007	2006	2005	2004	2003		
		38.28%	41.13%	37.16%	33.60%	35.28%	2007 Sample Calculation	
Step 1	Use the Federal agreement or lease sales volume of gas including carbon dioxide (CO ₂) as entered in field 15 of the Report of Sales and Royalty Remittance Form MMS-2014 (Form MMS-2014).	Sales Volume			10,000	Mcf		
Step 2	Determine the treating, dehydration and other fees charged by Williams. This is the actual fee paid on a Mcf basis after all discounts, rebates and other adjustments to the fees are made.	Fee			\$1.00	/ Mcf		
		Fee paid				\$10,000.00		
Step 3	Calculate the amount of the fee paid on the sales volume that is apportioned to the transportation allowance. The annual factor used in this step is found above, proceeding Step 1.	Annual Factor			38.28%			
		Factored Amount				\$3,828.00		
Step 4	Calculate the percentage to apportion the fee determined in Step 3 to royalty bearing gas only. In this example, the gas volume contains 12% CO ₂ and the delivery maximum limit in the transportation contract for CO ₂ is 2% so 90% of the total gas sales volume is royalty bearing. The actual fees paid are on the total sales volume therefore 90% of fees are allowed.	Percentage			90%			
Step 5	Calculate the value of the fee apportioned to the royalty bearing gas volume using the percentage calculated in Step 4. The resulting value is 90% of the value of \$3,828.00 calculated in Step 3.	Royalty Bearing Amount			\$3,445.20			
Step 6	Calculate the value of the Part 1 transportation deduction by applying the lease or agreement royalty rate. In this example 12.5% is used.					12.5%		
		Part 1 Transportation Deduction				\$430.65		

Part 2

Deductible Amount of Fuel Used

		Annual Factor:						
		2007	2006	2005	2004	2003		
		9.73%	9.73%	9.73%	9.73%	9.73%	2007 Sample Calculation	
Step 1	Use the Federal agreement or lease sales volume of gas including carbon dioxide (CO ₂) as entered in field 15 of Form MMS-2014.	Sales Volume			10,000	Mcf		
Step 2	Determine the amount of the agreement or lease gas in MMBtus using Gas Btu as entered in field 16 of Form MMS-2014 times the Sales Volume entered in field 15.	Btu Factor			950	Btu / Mcf		
		Gas MMBtu				9,500	MMBtu	
Step 3	Determine the agreement or lease sales value of gas as entered in field 17 of Form MMS-2014.	Sales Value					\$28,500.00	
Step 4	Calculate the value of the total lease or agreement fuel used by applying the actual percentage charge of fuel used which is typically found in your contract and/or statement to the sales value determined in Step 3. In this example 7% of the sales value is used.	Fuel Percentage					7%	
		Fuel Value						\$1,995.00
Step 5	Calculate the value of the fuel used apportioned to the transportation deduction. The annual factor used in this step is found above, proceeding Step 1 which is 9.73% for all time periods.	Annual Factor					9.73%	
		Factored Amount						\$194.11
Step 6	Calculate the percentage to apportion the value of the fuel used as determined in Step 5 to royalty bearing gas only. See Part 1 Step 4 for the percentage to use in this step.	Percentage					90%	
		Royalty Bearing Amount						\$174.70
Step 7	Calculate the value of the Part 2 transportation deduction by applying the lease or agreement royalty rate. In this example 12.5% is used.							12.5%
		Part 2 Transportation Deduction						\$21.84
		Sum of Part 1 and Part 2 Transportation Deductions						\$452.49