United States Department of the Interior
MINERALS MANAGEMENT SERVICE
Washington, DC 20240

OCT - 4 2005

Dear Reporter:

This letter supersedes the "Dear Operator/Payor" letter dated April 22, 1996, regarding reporting and payment of royalties on coalbed methane. That letter primarily addressed coalbed methane production from the San Juan Basin in New Mexico. A number of reporting changes have occurred since 1996. This letter applies to coalbed methane production from all Federal and Indian leases.

Reporting Coalbed Methane Production

For general information on reporting production, please refer to Minerals Management Service (MMS) *Minerals Production Reporter Handbook* (2002). Please note that all operators must report using the Oil and Gas Operations Report, Form MMS-4054 (OGOR) effective with the October 2001 report month. Report coalbed methane production volumes on the OGOR in the same manner as conventional gas production, with the exceptions stated below.

A. Volume Reporting

- Report the total volume and the Btu content of gas produced and measured at the Bureau of Land Management (BLM) approved royalty measurement point on the OGOR as a gas transfer (Disposition code 11).

- Report the eleven-digit gas plant identifier in the Gas Plant Number field on the OGOR-B for the plant downstream of the BLM-approved measurement point that receives and treats (removes carbon dioxide, compresses, and dehydrates) the gas.

- If gas is treated at more than one plant, report the numbers of each plant on separate lines on the OGOR-B, as well as the volume in thousand cubic feet (Mcf) going to each plant. Use Disposition code 11 more than once if the gas plant numbers are different.

- Report the percentage of carbon dioxide in the gas stream, as determined at the BLM-approved royalty measurement point, in the Comments Section.

B. Volume Measurement

- Production from each lease, unit, or communitized area is measured and reported on separate OGORs.

- Unless BLM approves a different method, the measurement at each lease, unit, or communitized area must meet BLM's measurement standards, and the volume and Btu content at the lease meter must be reported on the OGOR.

- Report gas used on or for the benefit of the lease (Disposition Code 20), and, therefore, not subject to royalty, consistent with BLM approvals. Do not report any gas used off the lease, unit or communitized area for compression, dehydration, or carbon dioxide removal (or other sweetening), etc., as gas "used on or for the benefit of" the lease, unit, or communitized area unless BLM specifically approves doing so.

- Coalbed methane field operations often involve performing these functions at different locations and in successive stages. For example, coalbed methane often comes from the wells at very low pressures and first goes through small compressors (frequently rotary screw compressors) that serve several wells. The gas then may go to field-wide treatment facilities. The treatment facilities often include dehydrators, carbon dioxide removal equipment, and additional compressors. These facilities usually are needed to put the gas in marketable condition. When the facilities are located off the lease, unit, or communitized area, you may not use produced gas to power the facilities royalty-free unless you request and receive specific permission to do so from the BLM.

<u>Valuing Coalbed Methane Production for Royalty Purposes</u>

A. Valuing Production from Federal Leases

The MMS knows of no situation in which carbon dioxide extracted from the coalbed methane is being saved and sold as a separate product. For purposes of this letter, we therefore assume that there are no such situations at the present time. Accordingly, value the coalbed methane as unprocessed gas under 30 CFR § 206.152 (2004). In the event that any situation arises in the future in which carbon dioxide (Product Code 17) is saved and sold after removal, value the coalbed methane as processed gas under 30 CFR § 206.153 (2004). In this situation, do not use the citations to the unprocessed gas rule to value the gases.

The total MMBtu's of the gas sold must be determined at the BLM-approved royalty measurement point. Multiply the total MMBtu's at the royalty measurement point by the unit price per MMBtu at the sales point to calculate the sales value.

Value coalbed methane produced from Federal leases that you sell at arm's-length under 30 CFR § 206.152(b). The value for royalty purposes usually will be the gross proceeds you receive under your arm's-length contract, if the gas is in marketable condition. If you dispose of coalbed methane under an arrangement that is not an arm's-length sale, value the gas under the first applicable benchmark at 30 CFR § 206.152(c).

Do not reduce the value for royalty purposes, either directly or indirectly, for the costs of placing the gas in marketable condition, or for marketing the gas for the mutual benefit of the lessee and lessor. If your arm's-length gross proceeds, or other measure of value, is reduced because the purchaser or any other party provides services to put the gas in marketable condition or to market the gas, then to determine royalty value you must add to your gross proceeds (or other measure of value) the amount by which it was reduced. See the discussion of the marketable condition requirement below.

Under some transportation contracts, the transporter provides services that are the lessee's responsibility to perform at no cost to the lessor, such as putting the gas in marketable condition. If services necessary to put production into marketable condition are bundled into the transportation fee, you must allocate the amount paid to the transporter between deductible transportation costs and non-deductible costs. If you are in such a situation and you do not know how to make this allocation, please contact the MMS at (800) 634-6423. See also the discussion of transportation allowances below.

B. Valuing Production from Indian Leases

To the extent specified in 30 CFR § 206.172(a), value coalbed methane that is produced from Indian leases located in an index zone under the provisions of § 206.172(b)-(g) and other applicable provisions referred to in those paragraphs. Value coalbed methane that is produced from Indian leases that are not located in an index zone, or that cannot be valued under § 206.172 for any other reason, by using § 206.174 and other provisions that apply when § 206.174 is used. If you sell carbon dioxide removed from coalbed methane produced from Indian leases, value the carbon dioxide under 30 CFR § 206.174 and use the regulations at 30 CFR §§ 206.179 and 206.180 (2004) to calculate your processing allowance.

C. Marketable Condition Requirements

In the case of coalbed methane, the services necessary to put gas in marketable condition ordinarily are gathering, dehydration, carbon dioxide removal (sweetening), and compression. *Amoco Production Co. v. Baca*, 300 F.Supp.2d 1 (D.D.C. 2003), *affirmed*, *Amoco Production Co. v. Watson, 410 F.3d 722* (D.C. Cir. 2005). Compression to put gas in marketable condition brings the gas to a pressure and condition necessary for the gas to enter the line which it must enter, and through which it must pass, to be delivered to the purchaser(s) in the market the gas serves. If a purchaser takes delivery at a pipeline interconnect, marketable condition is the pressure and condition necessary for the gas to enter the line into which the purchaser takes delivery and through which it then further moves the gas.

Particularly in the case of coalbed methane, functions necessary to put the gas in marketable condition may be performed in phases or stages and at different physical locations. For example, coalbed methane initially surfacing at very low pressures may be compressed to higher pressures, and ultimately to the relevant pipeline pressure, through more than one compressor in succession. Depending on the circumstances, all or a substantial part of the compression performed at more than one compressor will be necessary to bring the gas to the relevant pipeline pressure. This issue was addressed in a valuation determination issued by the Assistant Secretary for Land and Minerals Management to Devon Energy Corp. on October 9, 2003. You may request a copy of the decision from MMS. In that decision and in previous decisions involving Amoco Production Company and Vastar Resources, the Assistant Secretary for Land and Minerals Management emphasized the following principles:

Where the market for gas is at or near the field, the practices of the purchasers will dictate what constitutes marketable condition. In that context, the sales contracts between the producers and the purchasers (or the transportation contract between the purchaser and the pipeline) establish the pressure, as well as the maximum carbon dioxide and water content requirements for the gas to be delivered into the line into which the buyer takes delivery and thereby marketed.

When the actual market is not in the field, the requisite pressure for the gas to be marketable is the pressure necessary for the gas to enter the line which it must enter, and through which it must pass, to be delivered to the purchaser(s) in the market the gas serves. Applying the same principle, if a purchaser takes delivery at a pipeline interconnect, the gas must be at a pressure necessary to enter the line into which the purchaser takes delivery and through which the purchaser then moves the gas. In each of these situations, that is the pressure necessary to meet the requirements of the "sales contract[s] typical for the field or area" (30 CFR § 206.151), regardless of whether the requisite pressure is specified in a sales contract or in a transportation contract.

Where — and in how many phases or steps — the lessee chooses to compress the gas to the necessary pressure is up to the lessee. But regardless of the physical processes or particular engineering scheme the lessee uses, the costs of compression to the relevant pipeline pressure are costs that must be borne by the lessee at no cost to the lessor.

There can be more than one market for gas produced from a particular field. The fact that some gas is marketable for one market does not make all the gas in the same condition marketable if other gas serves a different market and requires more compression.

In general, a lessee is not required to compress the gas to the pressure necessary for the production to be in marketable condition more than once at its own expense.

Similar principles apply to dehydration and the sweetening of the gas by removing the CO_2. The lessee's obligation under longstanding rules is to dehydrate coalbed methane and to remove the CO_2 to the level required for delivery to the relevant pipeline (as necessary for sale under contracts that are typical for the disposition of gas produced from the field or area), regardless of whether the required water vapor or carbon dioxide level is specified in a sales contract or a transportation contract. The physical location of the dehydrator(s) and other treatment facilities does not control whether the costs of a particular facility are necessary to put production into marketable condition.

Marketable condition regulations are found at 30 CFR §§ 206.152(i) and 206.153(i). If you have a situation where you are uncertain of what costs are deductible or need further guidance on how to report, please contact us and we will work with you.

D. Transportation Allowances

If you sell the gas or establish value for the gas at a location downstream from the BLM-approved royalty measurement point, you may report a transportation allowance for your reasonable, actual, and necessary costs of transporting the royalty-bearing portion of the coalbed methane from the royalty measurement point to the point of sale. For gas produced from Federal leases, use the regulations in 30 CFR §§ 206.156 and 206.157 (2004) and the instructions in Chapter 6 of the Oil and Gas Payor Handbook, Volume III — Product Valuation (2001) to calculate your transportation allowance. For gas produced from Indian leases, if you value the gas under 30 CFR § 206.174, use the regulations at 30 CFR §§ 206.177 and 206.178 (2004) and the instructions in Chapter 6 of the Oil and Gas Payor Handbook, Volume III to calculate your transportation allowance. If you value gas produced from Indian leases under § 206.172, do not separately calculate or deduct a transportation allowance.

In general, the regulations provide that:

- Transportation charges must be allocated to all products produced and transported.
- Only deduct those costs allocated to the products that are royalty-bearing and only deduct them from the value of the royalty-bearing products to which they are allocated.

As stated above, we know of no operation in which the carbon dioxide component of the coalbed methane is saved and sold after removal. The regulations require that the costs of transporting carbon dioxide are deductible from the value of the carbon dioxide. When it is not sold, you may not deduct the share of the transportation costs allocable to the carbon dioxide from the methane gas. In addition as explained above, the removal of carbon dioxide is a cost of placing the gas in marketable condition.

However, you may include in the methane component of transportation costs the amount of carbon dioxide allowed in the main transmission line. For example, assume the following:

1. Your gas stream initially includes 90 percent methane and 10 percent carbon dioxide.
2. The main transmission line allows 2 percent carbon dioxide in the gas stream.
3. You, or another person, removes 80 percent of the carbon dioxide and sells the methane with 2 percent carbon dioxide entrained.

On these facts, you may include the costs of transporting the remaining 2 percent carbon dioxide volume when calculating your transportation allowance for the methane, whether that transportation takes place between the royalty measurement point and the treatment plant or downstream of the treatment plant (that equates to 92 percent of the total transportation cost upstream of the carbon dioxide removal facility).

You may not include in a transportation allowance the costs of any process, including fuel, necessary to put the gas in marketable condition. This includes, but is not limited to:

- Gathering, which includes movement of the gas to the BLM-approved royalty measurement point;

- Dehydration to the level required for delivery to the relevant pipeline as necessary to fulfill the requirements of the sales contracts that are typical for the disposition of gas produced from the field or area, as explained above;

- Carbon dioxide removal; and

- Compression to the pressure necessary for the gas to enter the pipeline which it must enter, and through which it must pass, to be delivered to the purchaser in the market the gas serves.

E. Processing Allowances

You may not take a processing allowance for your costs of removing carbon dioxide, unless you sell the carbon dioxide. If you sell the carbon dioxide, you may deduct these costs from the value of the carbon dioxide, as explained above. You may also not take a transportation allowance for the costs of removing carbon dioxide. See *Amoco Prod. Co. v. Watson, supra.*

Reporting Coalbed Methane Royalties

For general information on reporting and paying royalties on gas, please refer to MMS' *Minerals Revenue Reporter Handbook* (2003). One difference between reporting conventional gas and coalbed methane royalties is in the product code. Since the November 2001 report month (October 2001 sales), you are required to report coalbed methane sales as Product Code 39 on the Form MMS-2014.

You may produce coalbed methane and conventional natural gas from the same property. If so, you need to report separate lines on the Form MMS-2014 for the coalbed methane portion and the conventional gas portion using appropriate product codes. If BLM has approved commingling the two streams of gas prior to the royalty measurement point, use a BLM-approved allocation method to determine the separate sales volumes for royalty reports.

Report the MMBtu content of any gas in the "Gas MMBtu" field on the Form MMS-2014. You must base the value reported in the "Sales Value" field as described in Section II of this letter, "Valuing Coalbed Methane Production for Royalty Purposes." If you have transportation allowances for both coalbed methane and conventional gas, report the applicable allowance on the same line corresponding to the appropriate product.

Please note that the citations to handbooks and 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 your coalbed methane production, we recommend you request valuation and reporting advice from Compliance and Asset Management (CAM). Please send your request to:

Compliance and Asset Management
P.O. Box 25165
Mail Stop 392B2
Denver, Colorado 80225

You may also contact Compliance and Asset Management at 1-800-634-6423.

Sincerely,

Lucy Querques Denett

Lucy Querques Denett
Associate Director for
Minerals Revenue Management