



IN REPLY
REFER TO

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 25165
DENVER, COLORADO 80225

Mail Stop 653

FEB 4 1988

MMS-RVS

Dear Payor:

New valuation and related regulations for oil and gas become effective March 1, 1988, and will apply to production occurring on or after that date. These regulations are at 30 CFR 202, 203, 206, 207, 210, and 241. They were published in the Federal Register on Friday, January 15, 1988, at 53 F.R. 1184 (oil) and 53 F.R. 1230 (gas). As a result of the issuance of these regulations, certain new instructions to royalty payors on Federal and Indian leases are required. These instructions relate specifically to product valuation and allowances, including a new requirement that the payor submit separate forms documenting transportation and processing allowances claimed on Form MMS-2014. These instructions, together with copies of the new allowance forms and details on how to complete them, are enclosed. Listed below are the various enclosures and the subjects covered:

Enclosure

- I. General Instructions, Including Changes Required by New Regulations
 - A. Allowances
 1. Due Dates for Allowance Reports
 2. Mailing Address for Allowance Reports
 3. Interest Charges/Losses of Previously Claimed Allowances
 4. Reporting for Transportation and Processing Allowance Adjustments
 5. Allowance Percentage Limits
 6. Extraordinary Gas Processing Costs
 7. Reporting for Allowances That Vary According to Volume/Value of Production

8. MMS Determination of Allowances for Certain Arm's-length Transportation and Processing Contracts
9. Changes to Form MMS-2014 Reporting -- Processing Allowances
10. Model Form MMS-2014 Reporting Changes
11. Additional Instructions on Reporting and Determination of Allowances
12. MMS Contact Point -- Allowance Issues and Reporting Forms

B. Valuation

1. Changes to "Dual Accounting" Calculation Requirements for Natural Gas Royalties
2. Percent-of-Proceeds Contract Reporting Requirements
3. MMS Contact Point - Valuation Issues

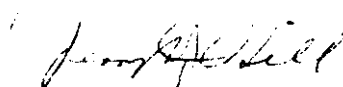
II. Oil Transportation Allowance Report (Form MMS-4110) and Instructions

III. Gas Transportation Allowance Report (Form MMS-4295) and Instructions

IV. Gas Processing Allowance Summary Report (Form MMS-4109) and Instructions

Questions related to valuation or allowance issues should be directed to the Minerals Management Service contacts provided in Enclosure 1. Questions related to Form MMS-2014 reporting should be directed to your Lessee Contact Branch representative. If your representative is unavailable or unknown, you may contact the Lessee Contact Branch at (303) 231-3288.

Sincerely,



Jerry O. Hill
Associate Director for
Royalty Management

4 Enclosures

A. Allowances

1. Due Dates for Allowance Reports

Before a transportation or processing allowance may be claimed on Form MMS-2014, the appropriate allowance report, including schedules as required, must be submitted to the Minerals Management Service (MMS). (See Enclosures II, III, and IV for copies of the reports and detailed completion instructions.) Allowances may be claimed retroactively for a period not more than 3 months prior to the first day of the month in which the allowance report is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. Where the lessee wishes to apply for an extension of the 3-month limit, it should submit its application, with supporting documentation, to MMS at the address shown in item A.12. of this enclosure.

Except where written allowance approvals by MMS are still in effect when the new regulations become effective, or where MMS has, at the request of the lessee, established different reporting requirements, the lessee must submit the initial allowance report no later than the end of the month in which the corresponding allowance deduction is reported on Form MMS-2014. Otherwise, the lessee will be subject to the payment of interest on the amount of any deduction taken in the 3 months prior to the first day of the month the report was filed, and subject to repayment of the deduction, plus interest, for earlier periods.

The initial allowance report under the new regulations will be effective for the reporting period beginning the month the lessee is first authorized to deduct the allowance. Thus, the allowance may be effective up to 3 months prior to the first day of the month in which the allowance report is filed with MMS. The allowance authorization then continues until the end of the calendar year or when the contract or rate ends or is modified, whichever is earlier. After the initial reporting period, the allowance report must be submitted within 3 months after the end of each calendar year, or after the applicable contract or rate terminates or is modified, whichever is earlier, unless MMS approves a longer period. During the period between the end of the previous allowance reporting period and the submittal of the new allowance report (assuming it is filed timely), the lessee shall continue to report, on Form MMS-2014, the allowance from the previous reporting period.

With the exception of non-arm's-length processing allowances for Outer Continental Shelf (OCS) leases, those transportation and processing allowances in effect as of March 1, 1988, will be allowed to continue until they terminate. (Allowances are "in effect" if written MMS approval has been given for an allowance for a time period, which has not yet expired.) Non-arm's-length

processing allowances for OCS leases will continue until they terminate or on December 31, 1988, whichever is earlier. Thus, for allowances that are in effect as of March 31, 1988, and until the existing approval terminates, the lessee needs to do nothing to validate the allowance claimed on Form MMS-2014. However, the lessee may, at any time in advance of the termination date and after the effective date of the regulations, submit the new allowance forms and begin reporting accordingly on Form MMS-2014.

For those lessees whose allowances are on a calendar-year basis and who elect to come under the new regulations effective March 1, 1988, the lessee would be required to submit, under the old regulations, actual cost data for the period January 1, 1987, through December 31, 1987, and for the period January 1, 1988, through February 29, 1988 (two separate submittals).

In order to avoid the requirement for two separate submittals of actual cost data, MMS hereby authorizes lessees whose allowances are on a calendar-year basis and who elect to come under the new regulations effective March 1, 1988, to include January and February 1988 actual cost data with the Calendar Year 1987 cost data and only submit one allowance request covering the period January 1987 through February 1988. The allowance request covering the 14-month period would be due no later than June 1, 1988, and July 1, 1988, for transportation and processing allowances, respectively.

The MMS may establish different reporting dates for individual lessees where such changes would result in more effective administration. Lessees will be consulted if MMS wishes a different reporting date.

2. Mailing Address for Allowance Reports

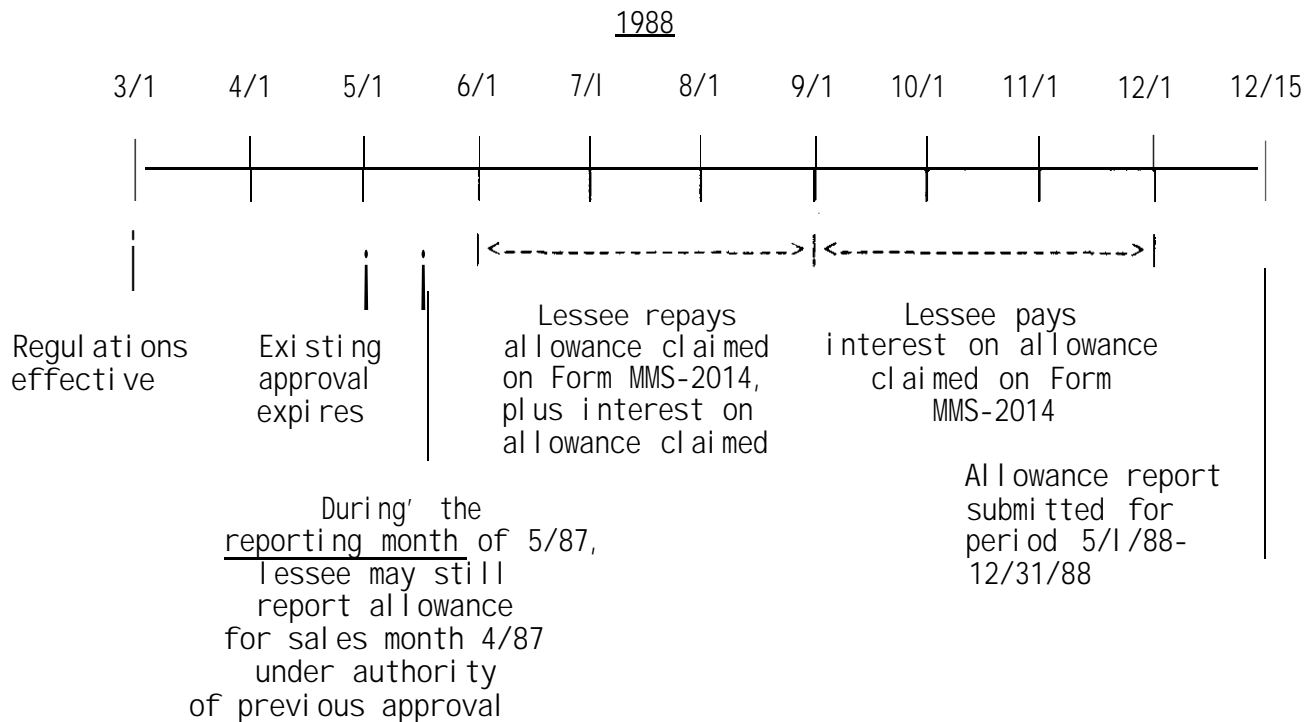
Completed transportation and processing allowance reports are to be submitted to the following address:

Minerals Management Service
Royalty Management Program/Allowances
P. O. Box 5200
Denver, Colorado 80217

3. Interest Charges/Losses of Previously Claimed Allowances

If MMS finds that a lessee has improperly determined a transportation or processing allowance, the lessee shall be liable for additional royalties, plus interest, or shall be entitled to a credit without interest. The lessee is liable for interest on those deductions taken in noncompliance with the regulations and on underpayments resulting from erroneous reporting. Likewise, the lessee must repay the full amount of any allowance claimed, plus interest, when such deduction is disallowed by the regulations.

For illustrative purposes, assume that (1) a lessee has existing approval of an oil transportation allowance through the sales month of April 1988, (2) the lessee continues to report the allowance throughout Calendar Year 1988 on Form MMS-2014, and (3) the lessee first submits its Form MMS-4110 to MMS on December 15, 1988. The following time line depicts the situation and shows when interest would be due and repayments of deductions would be required.



Thus, the lessee in this example would have to repay the allowances it claimed over the reporting months June through August 1988, plus interest on these deductions. The lessee would retain the deductions for the reporting months from September through November, but would pay interest on these deductions calculated to December 15.

Payors should be aware that MMS is planning to implement an automated system to monitor allowances reported on both the allowance reporting forms and Form MMS-2014. For example, differences between data reported on the allowance forms and Form MMS-2014, or nonsubmission of allowance reporting forms where allowances are deducted on Form MMS-2014, may dictate closer review of individual allowances. Further analysis of case details may result in partial or total disallowance of deductions already claimed or in assessment of interest, or both. Thus, it is in the best interest of the lessee to file its allowance reporting form timely and accurately.

1/ These reporting months cover the sales months May through July 1988.

4. Reporting for Transportation and Processing Allowance Adjustments

The new regulations at 30 CFR 206 have no provisions requiring changes to procedures for adjusting transportation and processing allowances claimed on Form MMS-2014. The existing transaction codes (11 for transportation, 15 for processing) and adjustment reason codes (04 for payor-initiated allowance adjustments, 34 for MMS-mandated allowance adjustments) are still applicable. For further information on adjustments, Volume II, Chapter 4, of the MMS Oil and Gas Payor Handbook should be consulted.

5. Allowance Percentage Limits

Transportation allowances are to be determined according to the new provisions at 30 CFR § 206.105 (oil) and 30 CFR § 206.157 (gas). However, the allowance claimed is not to exceed 50 percent of the value of the product at the point of sale on a selling arrangement basis (meaning the individual contractual arrangement under which sales or dispositions of lease products are made) unless MMS approves a lessee's application for exception. Likewise, processing allowances are to be determined according to the provisions of 30 CFR § 206.159, but such deductions are not exceed 66-2/3 percent of the value of each gas plant product^{2/} at the tailgate of the plant, unless MMS approves a lessee's application for exception. However, under no circumstances may the value for royalty purposes under any selling arrangement (transportation) or for any gas plant product (processing) be reduced to zero.

Until such time as a lessee's application for exception to the 50 percent transportation allowance limit or the 66-2/3 percent processing allowance limit is approved by MMS, the lessee may not report, on Form MMS-2014, allowances in excess of these limits. Likewise, the allowance report forms filed by lessees should not reflect allowance rates in excess of these limits until or unless MMS approval is obtained. If a lessee wishes to make application to MMS for an exception to these percentage limits, it should file its application, including supporting data, with MMS at the address shown in item A. 12. of this enclosure. If and when approval of an exception is granted, MMS will provide the lessee with revised reporting instructions.

^{2/} "Gas plant products" means separate marketable elements, compounds, or mixtures, regardless of form, resulting from processing gas, excluding residue gas. Thus, in addition to natural gas liquids, which are considered one product for reporting on Form MMS-2014, products of gas processing such as nitrogen, sulfur, and carbon dioxide, if marketable, are considered gas plant products.

6. Extraordinary Gas Processing Costs

A new provision at 30 CFR § 206.158(d)(2)(i) permits lessees to apply to MMS for approval of "extraordinary" gas processing costs in addition to any other processing allowance to which the lessee is entitled. This type of allowance will only be granted where the lessee can demonstrate that the costs incurred are, in reference to standard industry conditions and practice, extraordinary, unusual, or unconventional. If a lessee wishes to make application to MMS for approval of extraordinary gas processing costs, it should file its application, together with the supporting data, with MMS at the address shown in item A.12. of this enclosure.

Until such time as a lessee's application for an extraordinary cost allowance is approved by MMS, the lessee should deduct against the appropriate gas plant product on Form MMS-2014 only the processing costs to which it is otherwise entitled under 30 CFR § 206.159, including processing costs in excess of 66-2/3 percent of the value of the gas plant product if approved separately by MMS. If and when a lessee's extraordinary gas processing allowance has been approved, MMS will provide the lessee appropriate Form MMS-2014 reporting instructions.

7. Reporting for Allowances That Vary According to Volume/Value of Production

Certain arm's-length transportation and gas processing contracts include rates that are dependent on the volume and/or value of product moved or processed; e.g., transportation contracts including a fixed charge per MMBtu or barrel plus a charge based on a percentage of the oil or gas moved, and gas processing contracts where the plant operator reserves a percentage of the natural gas liquids as its fee. Thus, as market conditions and product prices change, the basis for the corresponding allowance changes. In such situations, the lessee is to complete the appropriate allowance report using the best available data to compute the current year's estimated rate. However, while the lessee may wish to submit a new allowance report each time market conditions, and hence the allowance unit rate, change during the reporting period, it is not required to do so. Rather, the lessee may report on its Form MMS-2014 the actual monthly costs incurred under the terms of its contract. This should result in fewer submittals of Forms MMS-4295, MMS-4109, and MMS-4110, and fewer adjustments to Form MMS-2014 during and at the end of the allowance reporting period.

8. MMS Determination of Allowances for Certain Arm's-length Transportation and Processing Contracts

Where (1) 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, or (2) an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product cannot be determined from the contract, the lessee shall propose an allocation procedure to MMS. The initial proposal must be submitted by June 30, 1988, or within 3 months after the last day of the month for which the lessee requests an allowance, unless MMS approves a longer period. The MMS will determine the allowance based upon the lessee's proposal and any other information MMS deems necessary. Until MMS issues its determination, the lessee may report on Form MMS-2014 the allowance determined in accordance with its proposed allocation procedure.

The lessee's proposed allocation procedure, including all supporting data, should be filed with MMS at the address shown in item A.12. of this enclosure. The MMS will provide revised reporting instructions, if necessary, at the same time it provides its allowance determination to the lessee.

9. Changes to Form MMS-2014 Reporting -- Processing Allowances

The allowance reporting sections of the MMS Oil and Gas Payor Handbook will be revised in the near future. Among the instructional changes will be a requirement that manufacturing (processing) allowances be reported with only the royalty quantity and royalty value fields completed on the appropriate line on the Form MMS-2014. Both of these fields should include minus signs. The sales quantity and sales value fields should be left blank. For sales months beginning March 1988, these changes are effective for all manufacturing (processing) allowances reported.

10. Model Form MMS-2014 Reporting Changes

Payors who use the Model Form MMS-2014 should be aware of an upcoming change resulting from implementation of the new regulations. Beginning in the near future, the Model Form will no longer preprint any lines with transaction codes 11 (transportation allowance) or 15 (manufacturing or processing allowance). This is because MMS has determined that it would be inconsistent to print those lines as though an allowance were expected to be reported when, in fact, a payor might not be entitled to report the allowance until or unless the new regulatory requirements had been met. Payors will be responsible for completing the necessary lines on the Form MMS-2014 or Model Form MMS-2014 to report allowances to which they are entitled. Instructions on reporting allowances can be found in the MMS Oil and Gas Payor Handbook, Volume II, pp. 3-161 through 3-166, Transportation Allowances, and pp. 3-167 through 3-174, Manufacturing Allowances. However, when reviewing the instructions for Manufacturing Allowances at pp. 3-167 through 3-174, please note the reporting changes discussed in item A.9. above.

11. Additional Instructions on Reporting and Determination of Allowances

Payors should be aware of several provisions in 30 CFR 206 relating to transportation and processing allowance reporting on Form MMS-2014. First, unless MMS approves a lessee's proposal for a different reporting procedure, each allowance must be reported as a separate line item. This means that allowances are not to be "netted" from the royalty due line, resulting in only one line being reported on Form MMS-2014 for the Accounting Identification Number (AID)/Product Code/Selling Arrangement combination.

Transportation costs must be allocated individually among products produced and transported. Transportation allowances are to be deducted on Form MMS-2014 on a selling arrangement basis as defined in the MMS Oil and Gas Payor Handbook.

The new rules provide that it may be appropriate in certain circumstances to include in transportation allowances the costs of transporting some non-royalty-bearing substances such as waste products, including water. For instance, transportation of water together with oil may be necessary in some cases in order to transport the oil. In such cases the total transportation costs would be allocated to the liquid products transported excluding volumes of waste products having no value. Except for waste products which have no value, transportation deductions shall not be allowed for non-royalty-bearing products without MMS approval.

Gas processing costs must be allocated among gas plant products, with natural gas liquids considered to be one product. A separate processing allowance must be determined for each gas plant product (natural gas liquids, sulfur, nitrogen, etc.) and processing plant relationship. These separate processing allowances must be reported with the appropriate AID/Product Code/Selling Arrangement combination on Form MMS-2014.

Where gas is processed, the processing allowance shall not be applied against the value of the residue gas unless an extraordinary gas processing allowance is approved by MMS. Where there is no residue gas, MMS may designate a gas plant product against which no processing allowance may apply.

Where the lessee wishes to terminate an allowance that is subject to the new regulations, it needs to submit a new allowance form. The new form should show the reporting period actual data in column 12. Column 13, current period estimated data, should be zero - filled to indicate termination of the allowance.

report for royalty purposes. These payors will only need to report the royalty value determined pursuant to 30 CFR § 206.152 or § 206.153, whichever is appropriate to their situation.

2. Percent-of-Proceeds Contract Reporting Requirement:

"Percent-of-proceeds" contracts refer to gas purchase agreements where title to the gas is transferred from seller to buyer in the field and payment by the buyer is based on a percentage of the buyer's proceeds resulting from processing the gas. Current MMS instructions for reporting royalties under such contracts allow payors to aggregate the values of residue gas and gas plant products allocable to a particular lease, less allowable deductions, and report this value on one line of Form MMS-2014, using Product Code 04 (unprocessed gas), the wellhead gas volume, and Calculation Method Code 03 (proceeds method). Since the lessee receives only one "net" payment from the buyer, no processing allowance lines are required to be reported. However, the lessee may, if it so desires, report product values and processing allowances separately; i.e., separate lines reporting royalty due on the residue gas, royalty due on gas plant products, and processing allowance deductions.

The new regulations at 30 CFR § 206.153 provide valuation standards for gas processed by the lessee and certain other gas production, including gas disposed of under percent-of-proceeds contracts, and 30 CFR § 206.154 governs the determination of quantities and qualities for computing royalties. The value of production under percent-of-proceeds contracts (and other production subject to 30 CFR § 206.153) will be the combined value of the residue gas and all gas plant products, plus the value of any condensate recovered downstream from the point of royalty settlement without processing, less applicable transportation and processing allowances. For residue gas and gas plant products, the quantity basis for computing royalties is the monthly net output of the plant.

Unlike current royalty reporting procedures for percent-of-proceeds contracts, the payor will, beginning with the March 1988 production month, be required to report individual product values on multiple lines on Form MMS-2014 with the appropriate product code and, for each gas plant product, the portion of the net output of the plant allocable to the lease. Processing allowances will also have to be claimed against gas plant products on separate lines on Form MMS-2014.

12. MMS Contact Point -- Allowance Issues and Reporting Forms

Questions related to allowance issues or procedures, and requests for additional copies of Forms MMS-4109, MMS-4110, and MMS-4295, should be directed to:

Chief, Transportation and Processing Valuation Branch
Royalty Valuation and Standards Division
Minerals Management Service
P. O. Box 25165, Mail Stop 653
Denver, Colorado 80225
(303) 231-3063

B. Valuation

1. Changes to "Dual Accounting" Calculation Requirements for Natural Gas Royalties

Payors should be aware of changes to the "dual accounting" requirements for reporting royalties where gas is processed. Dual accounting refers to a comparison between (1) the combined value, for royalty purposes, of the residue gas and gas plant products resulting from processing the gas, less applicable processing and transportation allowances, plus the value, for royalty purposes, of any condensate recovered downstream of the point of royalty settlement without processing, and (2) the value, for royalty purposes, of the gas prior to processing. The greater of these two values is the value for royalty purposes.

Currently, dual accounting is required whenever gas produced from OCS leases is processed by the lessee. For onshore Federal and Indian leases, dual accounting is required whenever a lessee (1) has its gas processed in a plant in which it owns an interest, (2) has its gas processed under a non-arm's-length processing agreement, or (3) sells its gas at the wellhead to an affiliate that subsequently has the gas processed. (The terms of individual leases--particularly Indian leases--may require dual accounting under other circumstances as well.)

The new regulations at 30 CFR § 206.155 provide rules for "Accounting for comparison," or dual accounting. This section requires accounting for comparison only where the lessee, or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or without a contract, processes the lessee's gas, and, after processing, the residue gas is not sold pursuant to an arm's-length contract. However, the requirement for accounting for comparison as contained in the terms of individual leases shall continue to govern.

As a result of the accounting for comparison changes, many payors will no longer have to perform a monthly comparison of wet gas and processed gas/gas plant product values to decide which way to

3. MMS Contact Point - Valuation Issues

Questions related to valuation issues or procedures, including general valuation standards, should be directed to:

Chief, Oil and Gas Valuation Branch
Royalty Valuation and Standards Division
Minerals Management Service
P.O. Box 25165, Mail Stop 653
Denver, Colorado 80225
(303) 231-3392