United States Department of the Interior

MINERALS MANAGEMENT SERVICE
WASHINGTON, DC 20240

MARCH 11, 1988

Dear Payor:

In the past, the Minerals Management Service (MMS) and its predecessor agency, the Conservation Division of the U.S. Geological Survey, issued royalty payment procedure letters to lessees. These letters documented the methods and values to be used in determining royalties due for processed and unprocessed gas produced from Federal leases on the Outer Continental Shelf (OCS). Usually, the letters were written after a lessee submitted its gas sales contract or when a lease began production. Royalty payment procedure letters were not issued for all OCS gas production, and the practice of routinely issuing the letters ceased after 1982.

Generally, the royalty payment procedure letters for unprocessed gas specified that the value for computing royalties would be based upon the lease delivery volume times the regulated price, or higher price if received, including adjustments for Btu value and any applicable gathering allowance.

Generally, the royalty payment procedure letters for processed gas required that royalty would be based on all residue gas and the lessee's share of any constituent products extracted from the gas attributable to the lease. The value of the residue gas to be used in computing royalties was based upon the regulated price, or higher price if received, including adjustments for Btu value and any applicable gathering allowance. Furthermore, the royalty payment procedure letters specified that royalty was due on 100 percent of the volume of any scrubber condensate recovered at the inlet of the gas plant that was attributable to the lease.

In royalty payment procedure letters for both unprocessed and processed gas, the regulated price prior to December 1, 1978, was described as the highest applicable ceiling rate then established by the Federal Power Commission (FPC) for the applicable vintage of gas. The regulated price from December 1, 1978, to the present was described as the highest applicable Natural Gas Policy Act of 1978 (NGPA) maximum lawful ceiling price for the gas. The letters also restated the regulatory requirement that the lessee perform a "dual accounting" when gas was processed by the lessee. No time limit was specified for the termination of these royalty payment procedures.

Beginning in 1982, gas prices started to decline owing to many factors, including the decline in prices of fuels that were alternatives to gas and direct gas-to-gas competition. As the gas market continued its decline, many purchasers reduced prices through the exercise of "market-outs." There are three basic types of "market-outs:" (1) Those resulting from the operation of the terms of the contract; e.g., market-out clause; (2) those resulting from either an amendment to the contract or contract renegotiation; or (3) those exercised by a purchaser in absence of either a market-out clause, a contract amendment, or a renegotiated contract. Further price declines increased the volumes of gas being sold through special marketing programs and on the spot market at prices substantially below applicable NGPA ceiling Prices. Consequently, the Prices a lessee received may have been substantially lower than the NGPA maximum lawful ceiling prices prescribed by the royalty payment procedure letters for use in computing royalties and those letters should have been modified to reflect the changes in the value of natural gas.

All royalty valuation orders, directives, and notices were superseded as of the effective date of the new 0il and Gas Product Valuation Regulations (March 1, 1988), except for those valuation determinations that exist for gas sold pursuant to warranty contracts. For the period January 1, 1982, through February 29, 1988, the MMS policy, in situations where the price received by the lessee is less than the price specified in the royalty payment procedure letter as the value upon which royalties are to be computed, is outlined below. Lessees and payors should be prepared to provide documentation that is sufficient for MMS to determine the proper value under this policy.

(1) When it is discovered that there is a royalty payment procedure letter in effect for a lease, MMS will determine in accordance with 30 CFR §§ 206.150, 206.151, and 206.152 whether or not the royalty value prescribed in the royalty payment procedure letter is reasonable. If MMS determines that the prescribed royalty value is not reasonable, it will redetermine the royalty value in accordance with the following valuation criteria.

  (a) Prices received under arm’s-length contracts will normally be accepted as the value for royalty purposes.

  (b) Prices received under non-arm’s-length contracts will normally be accepted as the value for royalty purposes if they are equivalent to prices received for like-quality gas sold under comparable arm’s-length contracts in the same field or area.

(2) In determining the royalty value under either the arm’s-length or non-arm’s-length contracts, no verbal agreements will be accepted.

(3) The MMS will not accept all retroactive price adjustments. The MMS will generally accept amended prices as of the effective date of the contract amendment. However, the effective data cannot be earlier than the date of the earliest notice from the Buyer to the Seller of the proposed contract amendment.

(4) When comparing prices for the purpose of determining royalty values, MMS generally will not mix NGPA categories of gas or compare regulated gas with nonregulated gas.

(5) If a lessee believes that the royalty value prescribed in the royalty payment procedure letter is unreasonable, it may request a redetermination of value from the MMS, Royalty Valuation and Standards Division (RVSD), P.O. Box 25165, MS-653, Denver, Colorado 80225, and must submit documentation to justify its claim that the price it received

represents market value for gas produced from the applicable field or area. Such documentation may include, but is not limited to, a gas sales contract, purchase statement, receipt, MMS oil and gas records, or other documentation considered necessary by MMS, which verifies that the lower price was in effect at or near the time of sale, shows the actual price received, and otherwise confirms that such lower price represents market value.

(6) The value of production for calculating royalty shall never be less than the gross Proceeds accruing to the lessee.

(7) This new policy applies only to the establishment of values for unprocessed gas and residue gas, and is not to be construed as superseding any other lease terms or regulatory requirements, such as the requirement for performing dual accounting when appropriate.

Any questions you may have regarding this matter should be directed to the Royalty Valuation and Standards Division.

Sincerely,

Wm D Bettenberg

Director

A COPY OF PUBLIC LAW 100-234 DATED JANUARY 6, 1988, ENTITLED “NOTICE TO LESSEES NUMBERED 5 GAS ROYALTY ACT OF 1987” IS PROVIDED FOR YOUR INFORMATION .