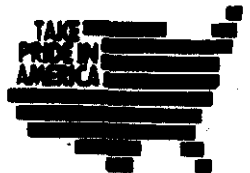




United States Department of the Interior



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

IN REPLY
REFER TO:

DAD-VA/RP, MS 662



Dear Payor:

Since the late 1950's, the Department of the Interior (Department) has maintained that royalty was due upon a Federal or Indian oil and gas lessee's receipt of a payment under a "take-or-pay" clause of a natural gas sales contract. The Minerals Management Service (MMS) has historically viewed take-or-pay payments as part of the total consideration received by the producer for the exclusive dedication of gas to the gas sales contract. Any consideration accruing to the lessee was viewed as royalty-bearing under the gross proceeds provision contained in the lease terms and operating regulations. Beginning in the early 1980's, audits by MMS found that many lessees had not reported and paid royalties on take-or-pay payments when they were received. Consequently, MMS issued orders requiring lessees to pay royalties and late-payment interest assessments on take-or-pay payments associated with Federal and Indian leases.

As a result of several orders issued by MMS requiring lessees to pay royalties on take-or-pay payments, two lawsuits were filed in Federal courts. The U.S. District Court for the Western District of Louisiana, in the case of Mesa Petroleum Company vs. U.S. Department of the Interior, found that the Department had no statutory, regulatory, or contractual authority to collect royalties on take-or-pay payments. The Western District Court defined "production" as oil and gas actually severed from the ground. Therefore, the Western District Court reasoned that when a purchaser made a take-or-pay payment, it did so in lieu of taking production. The Court ruled that when no production occurs, the Department is not authorized to collect royalties.

The U.S. District Court for the Eastern District of Louisiana, in Diamond Shamrock Exploration Co., et al. vs. Donald P. Hodel, et al., upheld the Department's reasoning that take-or-pay payments are part of the total consideration received by the lessee and ruled that the Department had the authority to require royalties on take-or-pay payments made to the producer. The Eastern District Court concluded that the term "production" included activities necessary for a producer to "maintain its ability to deliver" gas. Thus, take-or-pay payments compensate a lessee for activities necessary to keep wells functioning and are payments for production. Both decisions were appealed and consolidated before the U.S. Court of Appeals for the Fifth Circuit.

On August 17, 1988, the Fifth Circuit Court rendered its decision on the consolidated appeals. This Court found that no royalties are due on take-or-pay payments unless or until gas is actually produced and taken. The applicable mineral leasing statutes and underlying regulations provide the Secretary of the Interior with the discretion to establish the Department's position in matters of valuation. The Department has accepted the conclusion of the Fifth Circuit Court. Take-or-pay payments will be viewed as attributable to future production

from Federal and Indian oil and gas leases. Royalty on that future production is not due until such time as that production is removed from the lease for delivery to the purchaser. The value of that production will be determined under the regulations in effect at the time that production occurs.

Therefore, consistent with the decision reached by the Fifth Circuit, royalties are not due on take-or-pay payments unless or until gas is actually produced and taken. Any payor that has made royalty payments to the MMS on take-or-pay payments received from a purchaser is eligible for consideration for a refund or recoupment of the royalties previously paid on the revenues received under the take-or-pay clause in its gas sales contracts when part or all of the make-up volumes have not been delivered to the purchaser. Also, any late-payment interest charges associated with royalties paid on take-or-pay payments are eligible for consideration for refund. All such refunds or recoupments of royalties and refunds of late-payment interest assessment are subject to MMS review and written approval.

Requests for refund/recoupment on previously paid take-or-pay royalty payments must be submitted in writing to:

Minerals Management Service-RMP
 Lessee Contact Branch
 Attention: Margaret Hinderliter
 P.O. Box 5760
 Denver, Colorado 80217

Requests for refunds for previously paid late payment interest assessments must be submitted separately, in writing, to:

Minerals Management Service-RMP
 Payor Accounting Branch
 Attention: Exception Processing Section
 P.O. Box 5760
 Denver, Colorado 80217

The refund/recoupment request must contain the following information:

1. A signed statement certifying that the request for refund or recoupment has not previously been submitted, that the overpayment has not been recouped, and that a refund for the amount shown is due and payable.
2. A request for the specific amount due.
3. An explanation of why and how the overpayment occurred.
4. A schedule, by lease, providing the following data for each production month:

For royalties:

- a. Royalty paid to MMS on past take-or-pay received;
- b. Correct royalty amount due, including any credits taken; and
- c. Royalty overpayment.

For late payment interest assessment:

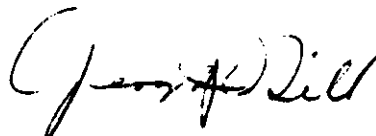
- a. Amount of assessment;
 - b. MMS bill number or a copy of the bill;
 - c. Corrected amount due; and
 - d. Assessment overpayment.
5. Sufficient documentation to support the validity of the overpayment; e.g., copies of canceled checks, copies of the royalty reports previously filed (including adjusted reports, and credits), and copies of worksheets used to calculate the revised royalty amount due and the resulting overpayment. The type and amount of data necessary to support each refund request will vary depending on the individual situation.
6. For royalties, if a refund is requested in lieu of permission to recoup, the payor must justify why a refund instead of recoupment is warranted.

Each request will be subject to review and, if circumstances warrant, audit by MMS. Upon completion of its review, MMS will provide the lessee with a written decision regarding its request, and instruction on its refund or recoupment. Additionally, all requests for refunds or recoupment on OCS leases are subject to the requirements of section 10 of the Outer Continental Shelf Lands Act of 1953, as amended. Please refer to chapter 4 of the MMS Oil and Gas Payor Handbook for more specific instructions regarding refunds and recoupments.

Each lessee that received an order from MMS to pay royalties and/or late-payment interest assessments on take-or-pay payments and appealed that order will be issued an Agency decision on its appeal and will be provided specific instructions by MMS regarding the disposition of its case-specific appeal.

Specific questions may be addressed to your Lessee Contact Branch or Payor Accounting Branch representative.

Sincerely,



Jerry D. Hill
Associate Of rector for
Royalty Management