United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 25165
Denver, Colorado 80225-0165

IN REPLY REFER TO:

MMS-VSD-OG
Mail Stop 3922

MAY 03 1993

Dear Payor:

The Minerals Management Service's (MMS) product valuation regulations always have required that royalty be paid on a value which cannot be less than the "gross proceeds" accruing to the lessee, for the disposition of minerals produced from Federal or Indian leases.[1] During the past several years, many lessees have entered into agreements with their purchasers settling various issues pertaining to the sale of production from Federal and Indian leases which have arisen under their contracts. These settlements frequently involve a lump-sum payment by the purchaser to be relieved of some or all of its obligations under the sales contract.

The purpose of this letter is to provide MMS Royalty Management Program (RMP) interpretation of how the various gross proceeds regulations apply to monies received under contract settlements. The RMP interpretation clarifies that lessees and other payors are required to pay royalties on contract settlement payments to the extent payments are attributable to minerals produced from the lease. Under this interpretation, some or all of a settlement payment is or will become royalty bearing if production to which specific money is attributable occurs.

Enclosure 1 is an explanation of how RMP's interpretation applies to payments made with respect to four issues or elements that are commonly the subject of contract settlement agreements, specifically:

1. Past pricing disputes;
2. Accrued take-or-pay liabilities;
3. Contract "buydowns;" and
4. Contract "buyouts."

If settlement payments pertain to other elements not specifically addressed in Enclosure 1, or if payments are received as a consequence of judicial litigation regarding sales contract obligations, the payments will be examined using principles consistent with those set forth in Enclosure 1.

---

[1] See former MMS regulations at 30 CFR §§ 203.200 (1987) (coal, gross value), 206.103 (1987) (onshore oil and gas), 206.150 (1987) (offshore oil and gas), 206.300 (1987) (geothermal, total consideration), and current regulations at 30 CFR §§ 206.102 (oil), 206.152 (unprocessed gas), 206.153 (processed gas), 206.257 (coal), 206.352, 206.355, and 206.356 (geothermal) (1992).

Enclosure 2 contains examples illustrating how RMP's interpretation applies to common types of contract settlement payment situations. These illustrations are not meant to be exhaustive; they simply highlight the key elements of the interpretation. The royalty consequences discussed in each of the examples apply only to the specific hypothetical given.

The enclosed RMP interpretation and examples do not address the issue of how lump-sum contract settlement payments are to be allocated among the several elements that are the subject of the settlement agreement between the seller and the purchaser, which is a necessary prerequisite to applying the interpretation set forth in Enclosure 1. In calculating royalties due on a contract settlement payment, payors need to allocate portions of the settlement payment to each issue resolved in the agreement; e.g., past pricing disputes, take-or-pay, buyout, and buydown. This should be based on the settlement agreement itself, or supporting documents used in the settlement negotiations, if such documents are available and if the allocation reflected in them is reasonable. In reviewing the reasonableness of a payor's allocations, RMP will apply its experience thus far derived from reviewing a substantial number of settlements. That experience has been that for past pricing disputes, the settlement has been for a high proportion of the accrued liabilities for that element. For take-or-pay, the settlement has reflected a small proportion of the take-or-pay liability accrued under the original contract. If RMP determines that the parties' allocation is unreasonable, RMP will determine an appropriate allocation.

The RMP will request from lessees, other royalty payors, and purchasers information regarding contract settlements related to Federal and Indian leases. The United States District Court for the Northern District of Oklahoma recently affirmed MMS' right to examine all such information in <u>United States v. Samson Resources Co.</u>, Civil No. 92-C-1030 B (March 19, 1993).

Lessees and other royalty payors should use this interpretation to determine the royalties due on amounts received under contract settlement agreements. Royalties due should be reported on the Report of Sales and Royalty Remittance, Form MMS-2014, according to the instructions given in Enclosure 3. If you have further questions regarding this interpretation of the regulations, please contact Mr. Martin C. Grieshaber at (303) 275-7240. If you have questions concerning the conduct of audits using this interpretation, please contact Mr. Kenneth M. Moyers at (303) 231-5129 or (303) 231-3185.

Sincerely,

James W Shaw

James W. Shaw
Associate Director for
Royalty Management

3 Enclosures

Enclosure 1

The Minerals Management Service (MMS) Royalty Management Program (RMP) Interpretation on Royalty Liability on Contract Settlement Payments

GENERAL PRINCIPLE

For Federal and Indian leases, royalties are due on payments received under contract settlement agreements to the extent the payments are attributable to production from the lease. In Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), the Court of Appeals for the Fifth Circuit ruled that royalties are not due on take-or-pay payments until the production to which the take-or-pay payment is attributable (under the Court's holding, so-called "make-up" gas) occurs.

Consistent with that ruling, the RMP interpretation and policy is that a payment or a portion of a payment is royalty bearing if the mineral to which the payment is attributable is produced and sold either to the original purchaser or a substitute purchaser, as part of the "gross proceeds" received for disposition of that production under applicable regulations. (See former MMS regulations at 30 CFR §§ 203.200 (1987) (coal, gross value), 206.103 (1987) (onshore oil and gas), 206.150 (1987) (offshore oil and gas), 206.300 (1987) (geothermal, total consideration), and current regulations at 30 CFR §§ 206.102 (oil), 206.152 (unprocessed gas), 206.153 (processed gas), 206.257 (coal), 206.352, 206.355, and 206.356 (geothermal) (1992).

SPECIFIC APPLICATION TO ELEMENTS OF CONTRACT SETTLEMENT PAYMENTS

PAST PRICING DISPUTES

That portion of the settlement payment made to resolve disputes regarding the proper price owed for minerals produced and sold from the lease before the settlement agreement (including, but not limited to, reimbursements for production-related costs, tax reimbursements, appropriate Natural Gas Policy Act price category, or nonpayment of contract purchase price by the purchaser, etc.) is royalty bearing when the lessee receives the payment.

TAKE-OR-PAY

<u>Settlement payments that are expressly subject to future recoupment through make-up deliveries are royalty bearing when and to the extent recouped</u>.

Where payments are made to settle past take-or-pay liabilities and the purchaser has the right to recoup the settlement payment through future deliveries of make-up production under an original, amended or successor contract, royalty is due on that portion of the settlement payment allocable to resolution of the take-or-pay obligation as the payment is applied to the make-up production.

<u>Settlement payments that are not expressly subject to future recoupment through make-up deliveries may be royalty bearing</u>.

Where payments are made to settle past take-or-pay liabilities, but the payment is not expressly recoupable through future deliveries of make-up production under an original, amended or successor contract, the royalty liability will be determined based on the status of the purchaser's make-up rights at the time of settlement and the circumstances involving future production from the lease.

Specifically, if the purchaser had make-up rights at the time of settlement and production continues from the lease, the portion of the settlement payment allocable to resolution of the take-or-pay obligation relates in part to the gas which the purchaser had the right to take under the make-up provisions of the original contract. Thus, if volumes that would have been make-up volumes; i.e., volumes in excess of the minimum take requirement under the original contract, are produced and taken by either the original or a substitute purchaser during the original contract's make-up period, then the portion of the settlement payment attributable to those volumes becomes royalty bearing as the volumes that would have been make-up volumes are produced. In this case, the payment is tied to a volume of production that may be produced after the settlement is effective. Royalties on the attributed portion of the settlement payment are due as this production occurs and are in addition to the royalties otherwise due on the product based upon the disposition to the purchaser of those volumes.

If the original purchaser's make-up rights were expired at the time of settlement, the portion of the settlement payment allocable resolution of past take-or-pay liabilities is not royalty bearing.

CONTRACT “BUYDOWNS”

That portion of the settlement payment made to reduce the price to be paid for future production to be taken by the original purchaser under an amended or successor contract is royalty bearing as future production occurs. The portion of the settlement payment allocable to this element is attributable to the production required to be taken during the remaining term of the original contract. Specifically, if the settlement agreement, or the payor’s documents or workpapers generated contemporaneously with the settlement agreement, includes a methodology to allocate this portion of the settlement payment to determine the amount attributable to each MMBtu of volume for which the price was bought down, MMS will accept that allocation method if it is reasonable. [2] If there is no such acceptable allocation, payors should use the following alternative method: the amount allocated to the buydown element is divided by the total MMBtu required to be taken under the amended or successor contract during the remaining term of the original contract. Under either the payor’s allocation method or the all owed alternative method, the resulting unit dollars per MMBtu are then added to the proceeds paid under the amended or successor contract to establish the gross proceeds received for the volumes (up to the required minimum under the amended or successor contract) produced and sold under that contract during the remaining term of the original contract as and to the extent that they are produced. This total sum establishes the minimum royalty value for the production. Royalties are due on this value as production occurs.

CONTRACT “BUYOUTS”

Payments made to extinguish a purchaser’s obligation to take volumes in the future under the contract being reformed or terminated are royalty bearing to the extent that production of the “bought-out” volumes (i. e., the reduction in the minimum take volume under the original contract) continues from the lease under any successor contract with any purchaser during the term of the original contract. The payment is royalty bearing because it compensates the lessee for lower prices in the future for the production foregone by the original purchaser. Some or all of the portion of the settlement payment allocable to this element is attributable to the bought-out volumes produced during the remaining term of the original contract. Specifically, if the settlement agreement (or the payor’s documents or workpapers generated contemporaneously with the settlement agreement) includes a methodology to allocate this portion of the settlement payment to determine the amount attributable to each MMBtu of bought-out volumes which is produced and sold to a substitute purchaser, MMS will accept that allocation method if it is reasonable. If there is no such acceptable allocation, payors should use the following alternative method: the amount allocated to this element is

[2] MMBtu is the volume unit for natural gas, which is the subject of most of the settlement agreements. If another mineral is involved, the appropriate unit of volume would be substituted.

divided by the total volume bought-out for the remaining term of the original contract. Under either the payor's allocation method or the allowed alternative method, the resulting unit dollars per MMBtu are then added to the proceeds paid under the substitute contract to establish the gross proceeds received for the bought-out volumes produced and sold under that contract as they are produced.

Payments made to extinguish a purchaser's obligation to take volumes in the future are not royalty bearing if there is no production in the future during the term of the original contract to which the payment can be attributed.

Enclosure 2

CONTRACT SETTLEMENT EXAMPLES

General Assumptions

S = seller/lessee
P_1 = original purchaser
P_2 = new or substitute purchaser

Original contract: 10-year term, 1 million MMBtu/year minimum take, $5/MMBtu contract price

EXAMPLE 1

Assumptions

1. P_1 owes S $250,000 for FERC Order 94 series reimbursements.

2. P_1 has an accrued take-or-pay liability of $3 million; the make-up period under the original contract has expired.

3. In year 5 of the contract, P_1 and S enter into a settlement agreement:
   P_1 pays S $5 million
   P_1's minimum take requirement is reduced to 500,000 MMBtu/year and P_1 takes that volume
   P_1's price is reduced to $2/MMBtu
   The term is 5 years from date of settlement
   There is no successor contract for bought-out volumes during the next 5 years.

Royalty Consequences

A. Any settlement amount allocable to resolution of the FERC Order 94 past pricing dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocable to take-or-pay is not royalty bearing because no make-up volumes are produced.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 (buydown) is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. The portion of the settlement payment allocated to buyout is not royalty bearing because no bought-out volumes are produced under any successor or substitute contract during the remaining term of the original contract in this example.

EXAMPLE 2

Assumptions are the same as example 1 except for bolded text:

1. P_1 owes S $250,000 for FERC Order 94 series reimbursements.

2. P_1 has an accrued take-or-pay liability of $3 million; the make-up period under the original contract has expired.

3. In year 5 of the contract, P_1 and S enter into a settlement agreement:
   P_1 pays S $5 million.
   P_1's minimum take requirement is reduced to 500,000 MMBtu/year, but P_1 takes more than that volume.
   P_1's Price is reduced to $2/MMBtu.
   The term is 5 years from date of settlement.
   There is no successor contract for bought-out volumes during the next 5 years.
   The new contract with P_1 allows a new make-up period for take-or-pay settlement payment.

Royalty Consequences (same as example 1 except for B.)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocated to take-or-pay becomes royalty bearing because P_1 takes in excess of 500,000 MMBtu/year within new make-up period; the volumes taken in excess of 500,000 MMBtu/year are make-up volumes. Royalties should be paid as the settlement payment is recouped through the delivery of the make-up gas volumes.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. The portion of the settlement payment allocated to buyout is not royalty bearing because no bought-out volumes are produced under any successor or substitute contract during the remaining term of the original contract in this example.

EXAMPLE 3

Assumptions same as Example 1 except bolded text:

1. P_1 owes S $250,000 for FERC Order 94 series reimbursements.

2. P_1 has an accrued take-or-pay liability of $3 million; the make-up period under the original contract for accrued take-or-pay liability has not expired; 3 years remain.

3. In year 5 of the contract, P_1 and S enter into a settlement agreement:
   P_1 pays S $5 million.
   P_1's minimum take requirement is reduced to 500,000 MMBtu/year and P_1 takes that volume.
   P_1's price is reduced to $2/MMBtu.
   The term is 5 years from date of settlement.
   The make-up rights for take-or-pay payments under the original contract are extinguished.

4. P_2 purchases 400,000 MMBtu/year at $2/MMBtu for 5 years.

Royalty Consequences (same as example 1 except D.)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. The portion of the settlement payment allocable to take-or-pay is not royalty bearing because no “make-up” volumes are taken in excess of original contract volumes.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to buyout is divided by the bought-out volume for the remaining term of the original contract (2,500,000 MMBtu (=500,000 MMBtu/year x 5 years)) to establish a unit incremental value ($/MMBtu), which is then added to the proceeds paid for the 400,000 MMBtu/year of bought-out volumes which P_2 takes over 5 years, and is royalty bearing as production occurs.

EXAMPLE 4

Assumptions same as Example 3 except bolded text:

1. P_1 owes S $250,000 for FERC Order 94 series reimbursements.

2. P_1 has an accrued take-or-pay liability of $3 million; the make-up period under the original contract for accrued take-or-pay liability has not expired; 3 years remain.

3. In year 5 of the contract, P_1 and S enter into a settlement agreement:
   P_1 pays S $5 million
   P_1's minimum take requirement is reduced to 500,000 MMBtu/year and P_1 takes that volume
   P_1's price is reduced to $2/MMBtu
   The term is 5 years from date of settlement.
   The make-up rights for take-or-pay payments under the original contract are extinguished.

4. P_2 purchases 600,000 MMBtu/year at $2/MMBtu for 5 years

Royalty Consequences (A. and C.. are same as examples 1 and 3; B. and D. are not)

A. Any settlement amount allocable to resolution of the FERC Order 94 dispute is royalty bearing upon payment.

B. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to take-or-pay is divided by the make-up volume to which P_1 had the right to take under the original contract (600,000 MMBtu (= $3,000,000 + $5/MMBtu)) to establish an incremental value. This value will be added to the otherwise applicable royalty value for the 100,000 MMBtu/year of "make-up" gas for 3 years and is royalty bearing as that production occurs.

C. The portion of the settlement payment allocable to reduction in price of the remaining 500,000 MMBtu/year from $5 to $2 is royalty bearing as production occurs over the next 5 years. Therefore, royalty is due on $2/MMBtu plus the amount allocated to each MMBtu of production in accordance with the method described in the interpretation.

D. In accordance with the method described in the interpretation, the portion of the settlement payment allocated to buyout is divided by the bought-out volume for the remaining term of the original contract (2,500,000 MMBtu (=500,000 MMBtu/year x 5 years)) to establish a unit incremental value ($/MMBtu), which is then added to the proceeds paid for the 500,000 MMBtu/year of bought-out volumes which P_2 takes over 5 years, and is royalty bearing as production occurs.

Enclosure 3

Please refer to the following matrix when paying additional royalties related to contract settlement payments. Note that Transaction Code (TC) 31 is to be used. Instructions for using this TC are not included in your Payor Handbook. For this TC, you must complete the following fields for each line:

- Accounting Identification Number
- Product Code
- Selling Arrangement
- Sales Month
- Transaction Code
- Sales Quantity
- Sales Value
- Royalty Quantity
- Royalty Value
- Payment Method Code

If under the interpretations contained in this letter you determine that certain payments you received now have a royalty liability because those payments are allocable to ongoing production, you should report and pay for the production from the date of the settlement to the current month in accordance with the instruction under Category 2a. You should continue to report future production as outlined in Category 2b or you may elect to make a lump sum payment. In this instance, you should follow the guidelines outlined in Category 3.

Future volume adjustments for settlement payments made using the guidelines in the matrix may require the correction of one or both lines depending on the situation. Please follow the reporting requirements outlined in the Payor Handbook or contact your Royalty Reports and Payments Branch Representative.

If you have any questions concerning reporting on the Report of Sales and Royalty Remittance Form MMS-2014, please contact Barbara Lambert on 303-231-3289.

ROYALTY REPORTING MATRIX

CATEGORY	INSTRUCTIONS	SALES MONTH	VALUE	VOLUME	TC
1.Past Pricing Disputes	On the Form MMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s) .	Month payment received.	Settlement payment amount.	Total volume related to payment.	31
Take-or-Pay, Buyouts and Buydowns					
2a. Production occurred from the date of the settlement to present and the monies are attributed to each month since settlement.	On the Form MMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s).	Actual production month.	Incremental value multiplied by the monthly production.	Actual monthly volume.	31
2b. Production will occur in the future. Requires 2 lines to be reported on the Form MMS-2014.	Report per instructions in Payor Handbooks.	Actual production month.	Sales price under the amended or successor contract.	Actual monthly volume.	01
	On the Form MMS-2014, report a separate line using the same AID/Product Code/Selling Arrangement as the related TC 01 line.	Actual production month.	Incremental value multiplied by the monthly production.	Actual monthly volume.	31
3. Lump-Sum Payments for Buyouts/Buydowns or Take-or-Pay for future periods.	On the Form MMS-2014, report a separate line for each current Accounting Identification Number (AID) to which the production relates. If they do not exist, then use your most recent AID(s).	Current sales month being reported.	Settlement payment amount.	Report a volume of 1.	31