

Shell Oil Company



P.O. Box 576
Houston, Texas 77001

June 3, 1993

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COLORADO DEPT. OF REVENUE
MINERAL AUDIT

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Mr. Ronald S. Brown
Appeals Assistant
Appeals and Litigation Support Division
Minerals Management Service (Mail Stop 9110)
Parkway Atrium Building
381 Elden Street
Herndon, Virginia 20070-4817

SUBJECT: DOCKET NO. MMS-92-0366-O&G
MC ELMO DOME UNIT
MONTEZUMA COUNTY, COLORADO

Dear Mr. Brown:

Shell Oil Company ("Shell"), on behalf of its subsidiary Shell Western E&P Inc. ("SWEPI"), hereby timely files its response to the Field Report from the State of Colorado, Department of Revenue, ("Report"), which was received by Shell on May 18, 1993.

The Report brands as untrue the statement by SWEPI that it is not trying to value all of SWEPI's in-kind deliveries to the Denver Unit at the July 1, 1986 contract price. In so doing, the Report is focusing on semantics rather than on the position that SWEPI is taking in this appeal. SWEPI buys its proportionate share of the January 1, 1982 contract volumes pursuant to the terms of the contract. With respect to its proportionate share of the volumes under the July 1, 1986 contract, SWEPI supplies such volumes in-kind. SWEPI believes that the volumes purchased under the 1982 contract should be valued at the 1982 price, while the volumes supplied in-kind under the 1986 contract should be valued at the 1986 price. The position taken in the Report is a distinction without a difference. The bottom line is that under both the 1982 and 1986 contracts, a portion of the volumes supplied are for the account of SWEPI, and SWEPI does not consider it equitable to value the volumes under both contracts as though they were supplied solely under the 1982 contract.

The Report contends that CO2 prices did not deteriorate during the 1982-1986 period as badly as SWEPI claims, and in support of such contention the Report analyzes five contracts entered into between 1982 and 1986 which had a higher price than did the January 1, 1982 contract. The ~~X~~ ~~4~~ ~~—~~ contract dated January 27, 1983, was to provide small volumes of CO2 prior to the commencement of deliveries under the January 1, 1982 contract, which did not occur

until 1984, and the contract price is not comparable to a long term large volume supply contract. The other four contracts mentioned on page 6 of the Report all contained a "floor" in the pricing provision, which artificially maintained a high price even though the commodity price of CO2 was rapidly decreasing.

The Report also contends that for certain periods the July 1, 1986 contract price was higher than the January 1, 1982 contract price. Of the 46 months covered in Attachment III to the Report, in only 9 months is the July 1986 contract price shown to be higher than the January 1982 contract price. And for a portion of those 9 months, the "floor" in the 1986 contract kept the price higher than the 1982 contract price. During the period October 1986 - December 1986, the actual calculated commodity price for CO2 under the 1986 contract was \$ X - 4 /MCF, and during the period October 1988 - December 1988 the actual calculated commodity price for CO2 was \$ X - 4 /MCF. Due to the "floor" in the 1986 contract, the price paid was \$ X - 4 /MCF during both of these periods.

This same situation also pertains to the Big Three contracts referred to on page 7 of the Report. The post 1987 contract contained a "floor" which kept the price higher than the pre 1988 contract which had been negotiated in 1984 without a price "floor".

The Report continues to take the position that the in-kind delivery contract was entered into prior to the July 1986 sales contract with the other working interest owners in the Denver Unit, and therefore the only proper price to value the in-kind deliveries was the January 1982 contract. Obviously, SWEPI did not agree to provide CO2 to the Denver Unit at a lower price than it was receiving for its January 1982 contract in a vacuum. At the time that SWEPI entered into the March 1, 1986 in-kind contract, the July 1, 1986 contract with the other Denver Unit working interest owners was being finalized. There is no difference in the terms of the two contracts. The in-kind delivery contract and the sales contract are both the result of the negotiations between the Denver Unit working interest owners and SWEPI. SWEPI merely decided to supply its share of the CO2 under the newly negotiated contract as an in-kind delivery rather than buying such CO2 under the sales contract, as it had done under the January 1982 contract. We do not think that such decision should penalize SWEPI by requiring it to pay royalty on the basis of the January 1982 contract price, while all of the other Denver Unit working interest owners are entitled to use the 1986 contract price for valuing royalty.

SWEPI maintains that the 1986 contract price is comparable to other arm's length contracts entered into by SWEPI from the McElmo Dome source field during this time period, and that the value attributable to the volumes supplied by SWEPI for its own account should be valued on the basis of the 1986 contract and not on the basis of the 1982 contract.

With respect to the issue of the statute of limitations, SWEPI recognizes that the Assistant Secretary, Land and Mineral Management, Department of the Interior, has stated that an administrative appeal of a demand for underpaid royalties is not the proper forum to address a defense claimed under 28 U.S.C. 2415(a). Amoco Production Company, MMS-89-0249-OCS (dated June 5, 1992). However, a federal district court has recently held that a failure to raise a statute of limitations defense at the administrative level waives the right to assert such defense at the judicial level. Mesa Operating Limited Partnership v. United States Department of the Interior, No. 92-C-843-E (N.D. Okla. October 16, 1992).

SWEPI continues to assert that the MMS is precluded by 28 U.S.C. Section 2415(a) from claiming additional royalties for the period prior to July 22, 1986.

Very truly yours,



William G. Riddoch
Senior Counsel
On behalf of Shell Western E&P Inc.

cc: Mr. F. David Loomis, Manager
Mineral Audit Section
Colorado Department of Revenue
999 Eighteenth Street
Suite 1025, North Tower
Denver, CO 80202

Mr. Erasmo Gonzales
Area Manager
Houston Area Compliance Office
Minerals Management Service
4141 N. Sam Houston Parkway, Suite 202
Houston, TX 77032

Signed: June 25, 1994

MMS-92-0366-0&G

: McElmo Dome (Leadville) Unit,
: Montezuma and Dolores Counties,
: Colorado; Bill No. 22924004

Shell Western E & P Inc.

: Appeal of Assessment of Additional
: Royalties on In-kind Deliveries of
: Carbon Dioxide Gas; Statute
: of Limitations

Appellant

: Appeal Remanded

Statement of Facts

Shell Oil Company's (Shell) subsidiary Shell Western E & P, Inc., (SWEPI) is the operator for the several working interest owners of the McElmo Dome Unit and produces carbon dioxide (CO₂) which is transported through the 500 mile Cortez Pipeline to oil fields in west Texas for use in enhanced oil recovery projects. SWEPI is also the operator for the several working interest owners of the Denver Unit, a purchaser of the Federal CO₂.

The record indicates that during portions of the period under review, there were 2 purchase contracts prescribing prices, and a supply contract governing in-kind deliveries of SWEPI's share of CO₂ produced at the McElmo Unit for use by the Denver Unit in Texas.

The initial purchase contract dated January 1, 1982, and executed between ~~_____~~ X ~~_____~~ provided for the sale of CO₂ to the Denver Unit at prices made subject to certain crude oil adjustment and transportation provisions. SWEPI states that the contract reflected arm's-length prices and contained take-or-pay provisions which required the purchaser to take or pay for minimum contract volumes.

The agreement was reviewed and found by the Minerals Management Service's (MMS) Royalty Valuation and Standards Division (RVSD) to be the equivalent of an arm's-length contract approved for use as a basis for the royalty valuation of the CO₂ production. By letter dated September 10, 1984, RVSD stated that: "MMS has determined that the contract between X-4 and X-4 dated January 1, 1982 is acceptable. The pricing terms contained in your contract to sell CO₂ to the Denver Unit are acceptable to MMS for establishing a value for royalty purposes."

The record shows that next in time, a March 1, 1986, in-kind delivery contract was executed by SWEPI for fulfillment of certain supply obligations to the Denver Unit by in-kind deliveries.

The second purchase contract dated July 1, 1986, between X-4 and the Denver Unit provides for the sale of CO₂ at prices lower than those negotiated for the January 1982 contract. SWEPI states that the Denver Unit working interest owners wanted to limit CO₂ purchases to the minimum take-or-pay volumes under the January 1, 1982, contract and to negotiate lower prices for any additional production. There is no indication in the record that the July 1986 contract was reviewed or approved by RVSD as a basis for paying royalties on the Federal CO₂.

SWEPI states that:

In each instance _____ X-4 _____
 X-4 found itself in a situation of selling CO₂ to
 the Denver Unit, of which _____ X-4 _____
 _____ X-4 _____
 _____ X-4 _____ for the Denver
 Unit and having the other major working interest
 owners negotiate an arm's length contract with X-4
 _____ X-4 _____ This procedure
 was found acceptable with respect to the January 1,
 1982 contract and we have no doubts that had the
 July 1, 1986 contract also been submitted for acceptance

Because the applicable regulations at 30 CFR 206.152(b)(1) (1993) for arm's-length contracts and 30 CFR 206.152(c)(1) (1993) for non arm's-length contracts each give great weight to the gross proceeds received under arm's-length contracts, it is proper to determine whether the 1986 contract is also arm's-length for these purposes. Accordingly, the appeal with respect to the post March 1, 1988, period should also be remanded to VSD to determine the method of valuing the CO, delivered in-kind to the Denver Unit.

The Appellant's arguments with respect to the statute of limitations are without merit.

Review:

Surnamed by the Assistant Solicitor, Energy and Resources and Royalty Management Program.

Recommended
Decision:

Remand the matter to the Office of State and Tribal Program Support for referral to VSD.

Option:

Recommended Decision Summary

Action: Signature the Associate Director

Appellant: Shell Western E & P Inc.

Docket Number: MMS-92-0366-O&G

Issue Assessment of Additional Royalties on In-kind-deliveries of Carbon Dioxide Gas; Statute of Limitations

Facts: SWEPI entered into 2 contracts for sale of CO₂ to the Denver Unit in Texas of which it was also the operator. The first dated January 1, 1982, between ~~_____~~ X - 4 _____ was specifically approved as the equivalent of an arm's-length contract for use as a basis for the royalty value of the production. The State of Colorado (State) contends that 60 percent of the CO₂ is supplied to the Denver Unit under this contract. The second was executed July 1, 1986, ostensibly by the same process as the 1982 contract, but provided lower prices and was not approved by RMP. This contract covers some 20 percent of the CO₂ supply to the unit. A third contract for supply of in-kind deliveries was executed on March 1, 1986.

By letter dated March 29, 1984, based upon an audit by the State, RMP assessed additional royalties in the amount \$908,631.35. SWEPI appealed only the portion of the assessment related to in-kind deliveries to the Denver unit which SWEPI had valued on the 1986 contract prices. SWEPI also appeals that portion of the assessment relating to more than 6 years prior to the demand letter.

Analysis: The State has acknowledged herein that the 1986 contract was executed with the same characteristics as an arm's-length agreement.

The provisions of 30 CFR 206.103 (1984) provide that in the absence of good reason to the contrary, the gas should be valued on the basis of prices paid for the major portion of like-quality production. The matter with respect to the period prior to March 1, 1988, should be remanded to determine whether the January 1, 1982, contract represented the major portion of like-quality production under the regulations in effect at the time.

by the MMS, the same result would have occurred.

An audit of the subject leases was performed for the period December 1, 1983, through September 30, 1989, by the Colorado Department of Revenue (State) pursuant to section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. 1735 (1988).

On the basis of the State's review, the MMS's Office of State and Tribal Program Support (OSTPS) by letter dated July 22, 1992, assessed additional royalties in the amount of \$908,631.35 for a number of alleged underpayments.

SWEPI has acceded to the portion of the order relating to the Wasson ODC In-Kind Delivery Meter 74222-502A, the South Wasson Clearfork In-Kind Delivery Meter 74222-509, the McElmo Creek Third Party Meter 74236-FM2, the royalty on severance tax reimbursements, and the transportation deduction limitations. With respect to the claimed underpayments attributable to certain transportation deduction limitations, the Appellant states that: "SWEPI has filed a Request For Exception Relief dated March 31, 1992 requesting retroactive relief to March 1, 1988. Therefore, SWEPI's concurrence with the MMS' findings is subject to its pending Request for Exception Relief."

The matter addressed here concerns the royalty valuation of the Federal CO₂ production delivered to the Denver Unit In-Kind Delivery Meter 74222-500B. Specifically, the State has concluded that additional royalties are due on the volumes delivered under the March 1, 1986, in-kind delivery contract, because SWEPI had failed to value the delivered production on the prices prescribed by the January 1, 1982, contract approved as the value basis by the RVSD. The State contends that during the period under review, the January 1982 contract accounted for 60 percent of the total Denver Unit's requirement and

the July 1986 contract accounted for approximately 20 percent of the unit's needs.

Shell concedes that the CO, delivered in-kind under the March 1986 agreement was valued on the basis of the lower July 1986 contract prices, but argues that it was proper under the applicable regulations to do so. On behalf of SWEPI, Shell appealed that portion of the order relating to the July 1, 1986, contract. Shell also appealed the portion of the royalty assessment applicable to the period prior to July 22, 1986, asserting that it is now barred by the Federal statute of limitations.

Issue

The issues presented by the appeal are (1) whether a portion of the RMP order is barred by the Federal statute of limitations at 28 U.S.C. 2415 (1988) and (2) whether the in-kind deliveries should be valued for royalty purposes on the basis of the higher priced contract approved by NMS.

Conclusions and Order

SWEPI argues that the applicable Federal statute of limitations bars the action to the extent that royalties are claimed to be due for the period prior to July 22, 1986, because they are more than 6 years before the demand letter dated July 22, 1992. In this respect, the Federal statute of limitations set forth at 28 U.S.C. 2415 (1988) provides in relevant part in paragraph (a) as follows:

[E]very action for money damages brought by the United States or an officer or agency thereof which is founded upon any contract express or implied in law or fact, shall be barred unless the complaint is filed within six years after the right of action accrues or within one year after final decisions have been rendered in applicable administrative proceedings required by contract or by law, whichever is later
• • *

Statutes of limitations operate directly on the remedies available to a claimant but do not affect the merits of the dispute or the underlying right of recovery. United States v. Studivant, 529 F.2d 673 (1976). Because the purpose of this proceeding is only to determine the underlying obligation for royalty, the alleged applicability of a statute of limitations does not operate to limit the period for which royalty may be found due, and does not limit administrative proceedings within the Department of the Interior. This proceeding is an administrative appeal, not a court action, and the statutory bar is inapplicable. Foots Mineral Co., 34 IBLA 285, 306 (1978); Anadarko Petroleum Corp., 122 IBLA 141 (1992). To this extent, the appeal applicable to the time period prior to July 22, 1986, is hereby denied.

The regulatory provision applicable to the royalty valuation of CO₂ produced from a Federal lease in effect for the period prior to March 1, 1988, was set forth at 30 CFR 206.103 (1984) and provided that:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

The State and the OSTPS contend that the deliveries made pursuant to the March 1986 in-kind delivery contract should be valued for royalty purposes on the prices prescribed by the January 1982 contract because the latter is the Denver Unit's principal CO₂ contract covering some 60 percent of its purchases, it is the higher price, and has been specifically approved by MMS as an arm's-length contract.

The provisions of 30 CFR 206.103 (1984) provide that in the absence of good reason to the contrary, the CO₂ should be valued on the basis of prices paid for the major portion of like-quality production. The question of how the production should be valued during the period prior to March 1, 1988, therefore should be remanded to determine whether the January 1, 1982, contract represented the major portion of like-quality production under the regulations in effect at the time.

For the period following March 1, 1988, the regulations applicable to the valuation of Federal CO₂ pursuant to an arm's-length contract provide at 30 CFR 206.152(b)(1) (1993) that with certain exceptions, the royalty value of gas shall be the gross proceeds accruing to the lessee.

The applicable provisions for establishing the royalty value of gas sold pursuant to non arm's-length contracts are set forth at 30 CFR 206.152(c)(1) (1993) which provide as follows:

The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors

shall be considered: price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas.

The record indicates that in approving the January 1982 contract prices as the royalty value of the CO₂, RYSD had concluded that that contract is of an arm's-length nature. The State has acknowledged herein that the similarly negotiated 1986 contract also has the characteristics of an arm's-length agreement.

Because the applicable regulations at 30 CFR 206.152(b)(1) (1993) for arm's-length contracts and 30 CFR 206.152(c)(1) (1993) for non-arm's-length contracts each give great weight to the gross proceeds received under arm's-length or comparable arm's-length contracts, it is appropriate to determine whether the July 1, 1986, contract is also a comparable arm's-length contract for purposes of valuing the in-kind deliveries. Accordingly, the portion of the order applicable to the period after March 1, 1988, should also be remanded to determine the proper method of valuing the CO₂ delivered in-kind to the Denver Unit under the new regulations effective March 1, 1988.

On the basis of the foregoing, the entire matter is remanded to the OSTPS for referral to the Valuation and Standards Division to determine the valuation methodology for the audited period.

This decision may be appealed to IBLA pursuant to 30 CFR Part 290 (1993) and 43 CFR 4.411 and 4.413 (1993). A copy of 43 CFR 4.411 and 4.413 (1993) is enclosed for reference. Notice of such appeal must be transmitted to the Director, Minerals Management Service, U.S. Department of the Interior, 1849 C Street, NW., Washington, D.C. 20240, within 30 days after the date of service of the decision. Copies of the notice of appeal and any statement of reasons,

written arguments, or briefs should be served upon the Associate Solicitor, Division of Energy and Resources, U.S. Department of the Interior, 1849 C Street, NW., Washington, D.C. 20240; and upon the Chief, Appeals Division (MS9110), Minerals Management Service, U.S. Department of the Interior, Parkway Atrium Building, 381 Elden Street, Herndon, Virginia 22070-4817.

Lucy R. Querques
Associate Director for Policy
and Management Improvement

Enclosure

bcc: Appeals (MMS-92-0366-0&G)
Reading
RMMLF

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 David Guzy, Chief
 Minerals Management Service
 POB 25165, MS 3601
 Denver, CO 80225

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STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capitol Annex
1375 Sherman Street
Denver, Colorado 80261



October 20, 1992

Mr. David Guzy, Chief
Office of State and Tribal Program Support
Minerals Management Service
P.O. Box 25165, MS 3601
Denver, CO 80225

Dear Mr. Guzy:

This field report is in response to Shell Oil Company's (Shell) Notice of Appeal and Statement of Reasons on Appeal dated August 25, 1992, regarding the Mineral Management Service (MMS) demand letter dated July 22, 1992, FBIL 22924004. The demand letter was issued as a result of an audit conducted by the Colorado Department of Revenue (State). This audit involved the review of Shell's subsidiary Shell Western E&P Inc. (SWEPI) federal royalty payments on carbon dioxide (CO₂) produced from the McElmo Dome Unit. The demand letter assessed additional royalties of \$908,631.35 for the following issues:

CO ₂ Price Valuation Issues	
Contract Pricing and Transportation Deductions	\$827,677.46
Royalty on Severance Tax Reimbursements.	80,953.89

SWEPI's Notice of Appeal sets forth two objections to the demand letter. The first objection is the issue of underpayment of royalty at the Denver Unit In-Kind Delivery Meter 74222-500B. In addition, SWEPI objects to royalty underpayments prior to July 22, 1986 as being precluded by the applicable statute of limitations.

SWEPI ARGUMENTS AND STATE RESPONSES

DENVER UNIT IN-KIND DELIVERY METER 74222-500B

GENERAL

Before the specific SWEPI arguments are addressed, the State feels that it is necessary to present the positions regarding the correct valuation of the Denver Unit In-Kind delivery.



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SWEPI's Statement of Reasons Supporting this Notice of Appeal is the following:

"The July 1, 1986 contract for the sale of CO2 by X-4 to the Denver Unit is an arm's-length contract negotiated four years after the initial sale of CO2 to the Denver Unit. Because of declining CO2 prices between 1982 and 1986, the 1986 contract is the arm's-length contract to be taken into consideration for purposes of valuing in-kind deliveries of CO2 by SWEPI from Denver Unit In-Kind Delivery Meter 74222-500B."

While the State reiterates its positions as cited in the Demand Letter dated July 22, 1982. The following was stated:

The State has determined that the applicable price for this delivery should be the contract dated January 1, 1982, between _____ X-4 _____ X-4 (determined to be an arm's-length contract by the Royalty Valuation and Standards Division (RVSD), MMS). This contract is considered to be the unit operator's principal CO2 purchase contract as it accounts for approximately 60 percent of the total CO2 delivered to the Denver Unit.

The MMS disagrees with SWEPI's contention that the time factor is controlling when determining comparable arm's-length contract in valuing production, subject to royalty, sold under non-arm's-length situations. The State's analysis of the referenced contract as the principal CO2 contract concludes that it meets the criteria set out in 30 CFR section 206.103 and 206.152(c)(1). The comparable contract applied by the State had the following attributes consistent with Federal regulations: the highest price; effective for the same production periods; the CO2 was from the same source fields (McElmo Dome Unit Production); accounted for the majority of the CO2 consumed at the Denver Unit (60 percent); and finally, it is consistent with past RVSD determinations.

The determination by RVSD that the January 1, 1982, contract contained pricing provisions acceptable in establishing a value for royalty purposes, was supported based on the fact that an arm's-length contract between _____ X-4 _____ dated March 1, 1983, covered sales of CO2 from the McElmo Dome Unit indirectly to the Denver Unit and the pricing provisions of this arm's-length contract were almost identical to the _____ X-4 _____ contract of January 1, 1982.

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SWEPI's contention that the July 1, 1986, contract should be the principal CO2 contract is incorrect. The July 1, 1986, contract is a non-arm's-length contract and covers less than 20 percent of the requirement to the Denver Unit. In addition, it was executed after the date of the CO2 in-kind agreement that is being valued. There were no arm's-length contracts covering sales to the Denver Unit other than the X-4 contract referenced above during the audit period.

SWEPI ARGUMENT I

SWEPI argues that the July 1, 1986 contract is an arm's-length contract. They state that the procedures for negotiating the July 1, 1986 contract were virtually identical to the procedures followed in negotiating the January 1, 1982 contract, which the MMS has accepted for purposes of establishing royalty value. Furthermore, SWEPI states: Obviously, it would have been to SWEPI's advantage to maintain the January 1, 1982 contract price in effect for all CO2 purchased by the Denver Unit, but, in fact, it was required to renegotiate a lower price for all volumes not subject to take-or-pay in the January 1, 1982 contract.

STATE RESPONSE I

The State does not dispute that the July 1, 1986 non-arm's-length contract between X-4 and the Denver Unit was entered into with the same characteristics as an arm's-length contract. The State did accept this contract as a basis for establishing value for the volumes of CO2 sold under this same agreement. What the State disagrees with is that the March 1, 1986 In-Kind delivery should be valued applying the Denver Units principal CO2 purchase contract dated January 1, 1982.

Although the State did accept the July 1, 1986 contract as an appropriate basis to value its contracted volumes, the MMS has never given such approval as given in the January 1, 1982 contract. Furthermore, neither the MMS nor the State has ever declared this July 1, 1986 contract to be the Denver Units principal contract.

Finally, the State does not agree that SWEPI gives up an advantage by renegotiating a lower contract. The State believes that Shell derives greater benefit as a company by producing and selling crude oil at the Denver Unit than it does by producing and selling CO2 at the McElmo Dome Unit. SWEPI is not considered to be at a disadvantage by solely adhering to its trust responsibilities (renegotiating lower CO2 prices) as operator of the Denver Unit.

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SWEPI ARGUMENT II

It is SWEPI's contention that its in-kind deliveries of CO2 to the Denver Unit to satisfy its share of CO2 purchase obligations under the July 1, 1986 contract should be valued in accordance with such contract. Just as it would be improper for SWEPI to value all of its share of CO2 deliveries to the Denver Unit at the July 1, 1986 contract price it is also improper for the MMS to value all of SWEPI's in-kind deliveries at the January 1, 1982 contract price

STATE RESPONSE

This argument is untrue. SWEPI is, in fact, trying to value all of its in-kind deliveries at the July 1, 1986 contract price. It should be understood that Shell's working interest portion of the CO2 consumed at the Denver Unit comes from two sources:

- 1) A percentage of the CO2 delivered under the January 1, 1982 contract (considered to be a comparable arm's length contract by MMS), and
- 2) The remaining share of Shell's Denver Unit CO2 requirement being filled by the March 1, 1986 in-kind agreement.

Of prime importance is that the State is trying to place a value solely on the amount of CO2 delivered under the March 1, 1986 in-kind agreement. The State has already valued the January 1, 1982 and July 1, 1986 delivery volumes at their respective contract prices. SWEPI is, in fact, proposing to value all of its CO2 in-kind deliveries at the July 1, 1986 contract price, since the remaining Shell CO2 is being supplied under the January 1, 1982 contract, which is considered by MMS to be an arm's-length contract.

SWEPI ARGUMENT III

SWEPI contends that because of the declining market for CO2 during the 1982-1986 period, the MMS should have accepted the July 1, 1986 contract as representing the value of CO2 at such time the contract was entered into. SWEPI states: The MMS's insistence on valuing SWEPI's in-kind deliveries of CO2 based on the January 1, 1982 contract ignores the decline in CO2 prices from 1982 to 1986. However, Congress addressed this concern in the Notice to lessees Numbered 5 Gas Royalty of 1987, P.L. 100-234, 101 Stat. 1719 (1988) ("NTL-5 Act"). The NTL-5 Act modified Section II.A.2 of NTL-5, which was applicable to the sales of CO2 from the McElmo Dome Unit to the Denver Unit, by providing that

the standard of basing valuation on the majority price for a field would not be followed if there was good reason to the contrary to not do so. Therefore, SWEPI concludes that the NTL-5 Act made it clear that dramatically dropping CO2 prices during the 1982-1986 period constituted good reason to the contrary.

STATE RESPONSE

The State feels that the circumstances surrounding CO2 and natural gas contract price provisions require further analysis.

- 1) First, the CO2 contract price provisions do not contain wording similar to natural gas contracts which allowed for the highest applicable ceiling rate established by the FPC or the highest maximum lawful price established by the Natural Gas Policy Act. The CO2 contracts simply calls for a commodity price which is generally adjusted quarterly, based on a factor of the current price of crude oil to the price of crude at the inception of the contract.
- 2) Moreover, the "NTL-5 Act" modified the NTL-5 method of calculation, which provided the base value for royalty purposes of certain gas production was the greater of the price received under the gas contract or the highest applicable ceiling rate then established by the Federal Power Commission. The applicable ceiling rate was subsequently interpreted to be the maximum lawful price established under the Natural Gas Policy Act of 1978. Therefore, it appears that the NTL-5 Act does not pertain to the sale of CO2.
- 3) If it is somehow determined that the NTL-5 Act affects the sale of CO2. The State feels that the CO2 contract price provisions provide for safe guards against such deteriorated market conditions, because the CO2 contract pricing provisions ties the CO2 quarterly prices directly to the cost of oil. If the price of oil goes down, the CO2 price goes down; likewise, if the price of oil goes up, so does the price of CO2.
- 4) In addition, the State does not believe that the CO2 price market had deteriorated as badly as SWEPI claims to cause the January 1, 1982 contract to be excessive. Again, the State feels that the CO2 price adjustments contained in the January 1, 1982 contract allows for the CO2 price to be adjusted to the specific market condition. The State has prepared a summary of SWEPI's various West Texas delivery point (contracts entered into between 1982 and 1986) Gross Unit Prices and Netback Prices for sample periods 1983

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through 1989, **See Attachment 1.** This analysis shows that the following contracts had a higher price than the Denver Unit January 1, 1982 contract:

— X - 4 — - Denver Unit dated 1/27/83 - Periods 12/83 and 02/84.
— X - 4 — dated 11/14/84 - Periods 03/85, 10/85, 9/88 & 1/89.
— X - 4 — dated 8/1/85 - Periods 05/86 through 07/89.
— X - 4 — dated 12/27/85 - Periods 05/86 through 07/89.
— X - 4 — dated 6/11/85 - Periods 05/86 through 07/89.

Furthermore, the July 1, 1986 contract does not materially X-4
— X - 4 — deviate from the January 1, 1982 contract for the sample periods identified. Also, the State has found that the July 1, 1986 contract price exceeds the January 1, 1982 contract price for the following periods: July 1986 through December 1986, and October 1988 through December 1988, See Attachment 2.

SWEPI ARGUMENT IV

SWEPI states: the MMS also argues that the July 1, 1986 contract (Delivery Meter 74222-500C) covers less than 20 percent of the CO2 requirements of the Denver Unit. Although this is correct, it should be irrelevant in the determination of which CO2 contract to use for determination of the value of SWEPI's in-kind deliveries. Valuation based strictly upon the fact that one particular contract provides the major portion of production does not adhere to the guidance of Congress under the NTL-5 Act. Market circumstances are clearly a good reason to avoid relying blindly on the major portion contract, and to base valuation on a more contemporaneously executed contract reflecting the changed market circumstances.

STATE RESPONSE

The point the State and MMS are making is that the January 1, 1982 contract is the major contract as it accounts for 60 percent of the total Denver Unit's requirement versus 20 or less percent provided by the July 1, 1986 contract. The January 1, 1982 contract supports the valuation guidelines set by the Royalty Valuation Standards Division for valuing in-kind deliveries based on the unit operators principal CO2 contract. The State would like to repeat their response to SWEPI Argument III in defense of the NTL-5 Act and the CO2 Market circumstances.

Mr. David Guzy
October 20, 1992
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SWEPI ARGUMENT V

SWEPI contends that the MMS should not direct its attention to the purchasing unit, but should look at arm's-length sales of CO2 from the source field to other purchasers, in order to compare arm's-length contracts for CO2 during the relevant time period. SWEPI's Attachment No. 5 reveals the arm's-length sales of CO2 from the McElmo Dome Unit by SWEPI during the period between the January 1, 1982 Denver Unit contract and the July 1, 1986 Denver Unit contract. This Attachment clearly reveals the decline in CO2 prices that occurred during this period. A comparison of these arm's-length contract prices supports SWEPI's contention that there was good reason to the contrary for the MMS to abandon its highest price for a major portion standard and for the MMS to accept the July 1, 1986 contract price as the value of SWEPI's in-kind deliveries.

STATE RESPONSE

The State objects to this argument because SWEPI is comparing CO2 prices effective for the third quarter of 1992. This comparison hardly portrays the CO2 prices prevalent during the audit period of 1983 through 1989. The State presents its Attachment 1 in support of its argument that the January 1982 contract was competitive with other arm's-length contracts negotiated for the sale of McElmo Dome Unit CO2 for periods 1983 through 1989. Finally, the State has found that the SWEPI Attachment No. 5 does not entirely disclose the contract pricing terms for the Big Three purchase location (Date of Contract 12/03/84). This contract contained pricing terms for pre-1988 and post-1987 contract commitments. The scenario presented by SWEPI reflects the pre-1988 commitments which is less than the July 1, 1986 Denver Unit contract, while the post-1987 commitment is approximately X-4 higher than the pre-1988 commitment and X-4 higher than the July 1, 1986 Denver Unit contract, See Attachment 3.

SWEPI ARGUMENT VI

SWEPI argues that although the March 1, 1986 in-kind delivery precedes the July 1, 1986 contract, it was clearly associated with efforts of the Denver Unit working interest owners to negotiate a new sales contract for the volume of CO2 required in excess of the January 1, 1982 contract take-or-pay volumes.

STATE RESPONSE

The State was unaware of any connection regarding the formation of the March 1, 1986 in-kind contract and the July 1, 1986

Mr. David Guzy
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contract when its comments were made. The State's argument is that the March 1, 1986 In-Kind delivery did in fact precede the July 1, 1986 Denver Unit contract. Since deliveries began prior to the formation of the July 1, 1982 contract, a price was needed to properly value the in-kind CO2 deliveries. The only proper price is the January 1, 1982 Denver Unit contract, which is considered by MMS and the State to be an arm's-length and the unit operators principal CO2 purchase contract.

STATUTE OF LIMITATIONS

SWEPI ARGUMENT

SWEPI asserts that the MMS is barred by the applicable statute of limitations from asserting a demand for payment of royalties from SWEPI from the subject federal leases prior to July 22, 1986.

STATE RESPONSE

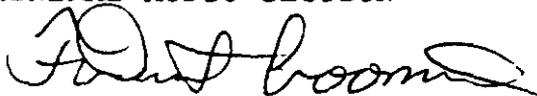
Because this issue is still pending in the courts, the State does not feel that it is necessary to elaborate any further on the SWEPI arguments cited in their Notice of Appeal. The State stands behind its arguments, surrounding the Statute of Limitations, presented to SWEPI in its Demand Letter dated July 22, 1992.

CONCLUSION

The State believes that the MMS should pursue the issues identified in the July 22, 1992 demand letter. The State feels that SWEPI has not successfully disputed its original citations and we also feel that we have been able to counter all of their arguments.

If you have any further questions or comments, please contact Mike Santos at 294-5140.

Sincerely,
MINERAL AUDIT SECTION



F. David Loomis
Manager

ATTACHMENT I

WEP!
 ADMINISTRATIVE FILE
 RESPONSE TO SNEPI APPEAL REGARDING MARKET CONDITION
 W/ OTHER WCELMO DONE UNIT ARM'S LENGTH SALES.
 ANALYSIS OF DELIVERY AND NET BACK PRICE PER WCF 1983 THRU 1989.

CO2 DELIVERY POINT	DATE OF CONTRACT	PRICE DESCRIPTION	12/83	02/84	11/84	03/85	10/85	05/86	06/86	03/87	11/87	04/88	09/88	01/89	07/89
SHELL-DENVER UNIT	01/01/82	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
ARCO/SHELL-DENVER UNIT	1/27/83	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
CO2 INC.-ALLRED	11/14/84	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
IG THREE-TATON	12/03/84	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
UNION TEXAS-WASSON ODC	01/18/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
ARCO-WILLARD UNIT	05/24/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
CORNELL-CORNELL UNIT	06/11/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
MOBIL-WCELMO CREEK	07/12/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
PHILLIP-EAST VACUUM	08/01/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
ENRON/WNG-ALLRED	09/01/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
UNION/ENRON-DOLLARHIDE SAME SALE TO HUNT & TRIACO	12/27/85	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												
SHELL/OTHERS-DENVER UNIT	07/01/86	GROSS UNIT PRICE NETBACK PRICE	_____ X-4 _____												

NOTE: FOR ARCO/SHELL CONTRACT DATED 1/27/83 PROVIDED FOR SALES OF CO2 FROM ARCO TO SHELL AND WAS CANCELLED 5/21/84.

ATTACHMENT II

SWEPI
 ADMINISTRATIVE FILE
 RESPONSE TO SWEPI APPEAL
 SCHEDULE OF DENVER UNIT CO2 UNIT PRICES 03/86 - 12/89.

DATE	CONTRACT DATE	DELIVERY/SALE	SWEPI WEIGHTED	ADDITOR WEIGHTED AVERAGE PRICE CALCULATION					PRICE PERCENTAGE
			PRICE	COMMODITY PRICE	TARIFF PRICE	TOTAL PRICE	TRANS. DEDUCTION	NET ROYALTY PRICE	OF 7/1/86 "X" TO 1/1/82 "X"
03/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
04/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
05/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
06/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
07/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
			X-4	X-4	X-4	X-4	X-4	X-4	
08/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
09/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
10/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
11/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							
12/86	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑	
	03/01/86	74222-500B							
	07/01/86	74222-500C							

SWEPI
 ADMINISTRATIVE FILE
 RESPONSE TO SWEPI APPEAL
 SCHEDULE OF DENVER UNIT CO2 UNIT PRICES 03/86 - 12/89.

DATE	CONTRACT DATE	DELIVERY/SALE	SWEPI WEIGHTED PRICE	AUDITOR WEIGHTED AVERAGE PRICE CALCULATION			PRICE PERCENTAGE OF 7/1/86 "K" TO 1/1/82 "K"
				COMMODITY PRICE	TARIFF PRICE	TOTAL PRICE	
01/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
02/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
03/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
04/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
05/87	01/01/82	74222-500A	X-4	X-4	X-4	X-4	X-4
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
06/87	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
07/87	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
08/87	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
09/87	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					

SVEPI
 ADMINISTRATIVE FILE
 RESPONSE TO SVEPI APPRAL
 SCHEDULE OF DENVER UNIT CO2 UNIT PRICES 03/86 - 12/89.

DATE	CONTRACT DATE	DELIVERY/SALE	SVEPI WEIGHTED PRICE	AUDITOR WEIGHTED AVERAGE PRICE CALCULATION			PRICE PERCENTAGE OF 7/1/86 "X" TO 1/1/82 "X"
				COMMODITY PRICE	TARIFF PRICE	TOTAL PRICE	
10/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
11/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
12/87	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
01/88	01/01/82	74222-500A	X-4	X-4	X-4	X-4	X-4
	03/01/86	74222-500B					
	07/01/86	74222-500C					
02/88	01/01/82	74222-500A	↓	↓	↓	↓	↓
	03/01/86	74222-500B					
	07/01/86	74222-500C					
03/88	01/01/82	74222-500A	↓	↓	↓	↓	↓
	03/01/86	74222-500B					
	07/01/86	74222-500C					
04/88	01/01/82	74222-500A	↓	↓	↓	↓	↓
	03/01/86	74222-500B					
	07/01/86	74222-500C					
05/88	01/01/82	74222-500A	↓	↓	↓	↓	↓
	03/01/86	74222-500B					
	07/01/86	74222-500C					

SWEPI
 ADMINISTRATIVE FILE
 RESPONSE TO SWEPI APPEAL
 SCHEDULE OF DENVER UNIT CO2 UNIT PRICES 03/86 - 12/89.

DATE	CONTRACT		SWEPI WEIGHTED PRICE	AUDITOR WEIGHTED AVERAGE PRICE CALCULATION				PRICE PERCENTAGE OF 7/1/86 "K" TO 1/1/82 "K"
	DATE	DELIVERY/SALE		COMMODITY PRICE	TARIFF PRICE	TOTAL PRICE	TRANS. DEDUCTION	
06/88	01/01/82	74222-500A	↑	↑	↑	↑	↑	↑
	03/01/86	74222-500B						
	07/01/86	74222-500C						
07/88	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						
08/88	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						
09/88	01/01/82	74222-500A	X-4	X-4	X-4	X-4	X-4	X-4
	03/01/86	74222-500B						
	07/01/86	74222-500C						
10/88	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						
11/88	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						
12/88	01/01/82	74222-500A	↓	↓	↓	↓	↓	↓
	03/01/86	74222-500B						
	07/01/86	74222-500C						
01/89	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						
02/89	01/01/82	74222-500A						
	03/01/86	74222-500B						
	07/01/86	74222-500C						

SWEPI
 ADMINISTRATIVE FILE
 RESPONSE TO SWEPI APPEAL
 SCHEDULE OF DENVER UNIT CO2 UNIT PRICES 03/86 - 12/89.

DATE	CONTRACT DATE	DELIVERY/SALE	SWEPI WEIGHTED	ADDITOR WEIGHTED AVERAGE PRICE CALCULATION			PRICE PERCENTAGE
			PRICE	COMMODITY PRICE	TARIFF PRICE	TOTAL PRICE	TRANS. DEDUCTION
03/89	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
04/89	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
05/89	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
06/89	01/01/82	74222-500A	↑	↑	↑	↑	↑
	03/01/86	74222-500B					
	07/01/86	74222-500C					
07/89	01/01/82	74222-500A	X-4	X-4	X-4	X-4	X-4
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
08/89	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
09/89	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
10/89	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
11/89	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					
12/89	01/01/82	74222-500A					
	03/01/86	74222-500B	↓	↓	↓	↓	↓
	07/01/86	74222-500C					

ATTACHMENT III

SWEPI

ADMINISTRATIVE FILE

RESPONSE TO SWEPI APPEAL

ANALYSIS OF SWEPI'S ATTACHMENT NO. 5 MCELMO DOME UNIT CO2 CONTRACTS

PURCHASE LOCATION	DATE OF CONTRACT	INITIAL DELIVERY	CURRENT DELIVERED PRICE \$/MCF	CURRENT NETBACK PRICE \$/MCF
DENVER UNIT	1/1/82	4/84	X-4	X-4
BIG THREE PRE 1988	12/3/84	1/86	X-4	X-4
BIG THREE POST 1987	12/3/84	1/86	X-4	X-4
WILLARD	5/24/85	4/86	X-4	X-4
EAST VACUUM	8/1/85	9/85	X-4	X-4
DENVER UNIT	7/1/86	7/86	X-4	X-4

NOTE: THE BIG THREE POST 1987 COMMITMENT IS BASED ON THE FOLLOWING PRICE CALCULATION: A COMMODITY PRICE OF \$ X-4 EFFECTIVE 1/1/88 WITH THE PRICE ADJUSTED ON THE 1ST DAY OF APRIL, JULY, OCTOBER, AND JANUARY IN ACCORDANCE WITH THE FOLLOWING FORMULA:

$$P = C2/C1 * P1$$

P = APPLICABLE PRICE (\$/MCF)

C2 = — X-4 —

C1 = \$ X-4

P1 = \$ X-4

PRICE SHALL NEVER BE LESS THAN \$: X-4

PLUS A TARIFF REIMBURSEMENT OF \$: X-4

SINCE THE AVERAGE CRUDE PRICE IS \$ X-4 THE COMMODITY PRICE IS \$ X-4 PLUS THE TARIFF REIMBURSEMENT OF \$ X-4 —



IN REPLY
REFER TO

United States Department of the Interior

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



MMS/RCD/OSTPS 2-4-87
MS 3601

Colorado
JUL 22 1992 Shell E&P, Inc.

CERTIFIED MAIL --
RETURN RECEIPT REQUESTED

RECEIVED

JUL 30 1992

Mr. Lee Hileman
Shell Oil Company
P.O. Box 4655
Smith Building, Room 2150A
Houston, Texas 77210-4655

**COLORADO DEPT. OF REVENUE
MINERAL AUDIT**

Dear Mr. Hileman:

The Colorado Department of Revenue (State), in accordance with Section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), has reviewed, subject to the scope limitations listed below, Shell Western Exploration and Producing Incorporated's (SWEPI), royalty obligations for carbon dioxide (CO₂) produced from Colorado Federal leases located within the McElmo Dome Unit, for the period December 1, 1983, through September 30, 1989. The Federal leases reviewed are enclosed as Exhibit A.

The State's review was limited in the following areas:

- 1) The review utilized unconfirmed CO₂ prices supplied by Mobil Oil Corporation (Mobil) for use in the Chevron USA, Inc. (Chevron) and Total Unit weighted average price calculations. The use of the Mobil prices is contingent upon future audit confirmation.
- 2) For the time period March 1, 1988, through September 30, 1989, the review utilized the Cortez pipeline tariff of \$0.39. The use of this tariff is contingent upon the transportation allowance appeal currently before the Division of Appeals, Minerals Management Service (MMS). Based on the outcome of the appeal this issue may be reexamined. Therefore, SWEPI is directed to maintain its records applicable to this issue.

The State's review indicates that, during the audit period, SWEPI underpaid royalties due the MMS by \$908,631.35, as follows:

<u>ISSUE</u>	<u>AMOUNT</u>
CO ₂ Price Valuation Issues	
Contract Pricing & Transportation Deductions	\$827,677.46
Royalty on Severance Tax Reimbursements	<u>\$ 80,953.89</u>
	<u>\$908,631.35</u>

SWEPI was notified of the State's preliminary findings of \$897,892, by letter dated December 18, 1991. Shell Oil Company (Shell), on behalf of SWEPI, responded by letter dated February 4, 1992, commenting on the aforementioned issues. The total royalties due per this order is higher than the amount given in the State's preliminary determination. This difference is a result of corrections to the State's calculations of the additional royalty due on Severance Tax Reimbursements. The referenced audit issues and computational revisions will be discussed in detail below.

STATUTE OF LIMITATIONS

SWEPI's Argument

SWEPI contends that, Section 2415(a) of Title 28, United States Code, provides for a 6-year limitations period with respect to Federal actions for money damages. This statute is applicable to claims for royalty on Federal leases and begins to run when the royalty was due or paid. Phillips Petroleum Co. v. Manuel Lujan, Secretary of the Department of the Interior, (N.D. Okla., October 18, 1989); appeal Docket No. 90-5122, 10th Circuit, June 29, 1990. The filing of the audit letter dated July 18, 1990, does not halt the running of the 6-year statute of limitations. Therefore, it is SWEPI's contention that, should a demand letter for underpayment of royalties be issued with respect to the McElmo Dome Unit then the applicable audit period cannot extend beyond 6 years from the date of such demand letter.

MMS' Response

The State and MMS have timely notified SWEPI of the audit engagement within the 6-year timeframe. MMS notified SWEPI by letter dated September 19, 1989, that an audit was to begin which would cover the period October 1, 1983, through September 30, 1989. Also, the State submitted an engagement letter (records request) to the Shell MMS resident auditor, dated July 18, 1990. Therefore, as a result of actions taken by the State and MMS to define the audit period (October 1, 1983, through September 30, 1989), we have in effect tolled any statute of limitations or records retention requirements.

It is MMS' policy that no statute of limitations exists in this case regarding underpaid royalty assessments. In accordance with Section 103 of FOGPMA, only a 6-year record retention requirement is cited. Therefore, the statute of limitations found at Section 307 of FOGPMA, 30 U.S.C. § 1755 (1982), applies

only to the collection of civil penalties assessed under FOGRMA and does not govern the obligation to pay royalty.

An IBLA decision, Forest Oil Corp., 111 IBLA 284 (1989), emphasizes MMS' policy, which states, in part:

. . . MMS contends that the relevant statute of limitations, should the Department bring suit to recover royalty underpayments, . . . is found at 28 U.S.C. § 2415(a) (1982), as modified by 28 U.S.C. § 2416(C) (1982). MMS would apply this statute *not from the time royalty was underpaid* (when the right of action accrued) but when MMS reasonably knew of underpayment, an exception found in 28 U.S.C. § 2416(c) (1982), . . .

The referenced IBLA decision has ruled that the statute of limitations in 28 U.S.C. 2415 (1982) relates to remedies rather than underlying obligations and does not apply to an administrative appeal under 30 CFR 290 (1991). Because SWEPI's claim regarding this order is an administrative appeal to determine the underlying obligation for royalty, rather than a court action, the statute of limitations is not applicable. The right to assess SWEPI additional royalties because of a prior underpayment remains in force.

In addition, the statute of limitations concerning collections of additional royalties beyond the 6 years prior to issuance of an MMS demand letter has been addressed in Foot Mineral Co., 34 IBLA 285, 306-308, 85 I.D. 171, 182-83 (1978) and MMS' position was upheld on review in court. United States v. Studivant, 529 F. 2d 673 (3rd Cir. 1976). Therefore, there is no statute to prevent MMS from collecting royalties due the Government.

CO₂ PRICE VALUATION AND TRANSPORTATION ISSUES

SWEPI's Arguments

As a result of SWEPI's review of the State's preliminary letter, SWEPI agrees with the State's findings concerning the South Wasson Clearfork In-Kind Delivery Meter 74222-509, the McElmo Creek Third Party Meter 74236-FM2, the transportation deduction limitation, and the royalty on severance tax reimbursements. SWEPI disagrees with the State's determinations of royalty underpayment with respect to: 1) the Denver Unit In-Kind Delivery Meter 74222-500B, and 2) the Wasson ODC Unit In-Kind Delivery Meter 74222-502A.

Denver Unit In-Kind Delivery Meter 74222-500B

SWEPI disagrees with the State that the applicable price in valuing, for royalty purposes, the in-kind delivery of CO₂ by X-4 to the Denver Unit, should be based on the price established by the January 1, 1982, contract for the sale of CO₂ by ~~_____ X - 4 _____~~ to the Denver Unit. SWEPI believes that the proper price should be based on the July 1, 1986, contract between X-4 and the Denver Unit. SWEPI states that the State has focused its determination solely on the price at which the major portion of the CO₂ is sold to the Denver Unit, and that the State has failed to

recognize that the Federal regulations also refer to time of production as a factor in determining comparable arm's-length contracts.

Wasson ODC In-Kind Delivery Meter 74222-502A

SWEPI disagrees with the State that SWEPI's in-kind deliveries to the Wasson Unit should have been valued on the basis of the ~~X-4~~ contract that accounted for nearly 63 percent of the Unit's CO₂ requirement. SWEPI believes that the proper price should be based on the November 17, 1984, contract between ~~X-4~~. Again SWEPI states, that the State has focused its determination solely on the price at which the major portion of the CO₂ is sold to the Wasson ODC Unit and that the State has failed to recognize that the Federal regulations also refer to time of production as a factor in determining comparable arm's-length contracts.

Finally, SWEPI's acquiescence to any of the preliminary findings does not preclude them from invoking the 6-year statute of limitations or requesting an exception to the 50 percent limitation for transportation deductions.

MMS' Response to the CO₂ Price Valuation and Transportation Issues

Federal regulations and instructions from MMS establish the value to be used in calculating royalties and also allows the Secretary of the Interior latitude in setting guidelines for allowing transportation deductions.

Title 30 CFR § 206.103 (1984), titled "Value basis for computing royalties," applies to the period December 1, 1983, through February 29, 1988, and states, in part:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. . . .

Effective March 1, 1988, Federal regulations at 30 CFR § 206.152(c)(1) (1988), provide guidelines for valuing gas sold pursuant to a non-arm's-length contract. The first benchmark for determining reasonable value states:

The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets

served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas.

In addition, MMS has established policy for valuing in-kind CO₂ deliveries. For in-kind deliveries MMS has determined that the applicable royalty value should be the delivery point, unit operator's principle CO₂ purchase contract price less actual cost of transportation (limited to 50 percent of the product's fair market value).

The authority of the Secretary (or the Secretary's designee) to determine the reasonable value of gas is reinforced in Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases No. 1 (NTL-1), Section III, titled, "Gas and Associated Liquids Production, Sales, and Royalty Requirements," which states, in part:

The value of all produced gas and associated liquid hydrocarbons will be established by the Supervisor. Such value will be based on the Supervisor's estimated reasonable value of both the natural gas and its entrained liquid hydrocarbons with due consideration being given to the highest price paid for a part or a majority of like quality production in the same field or area, to the price(s) received by the operator, to the Btu content of the gas, and to other relevant matters. . . . [Emphasis added.]

Section III of NTL-1 also shows that the NTL is intended to apply to sales of carbon dioxide gas by stating in part:

. . . Non-hydrocarbon byproducts such as sulfur and carbon dioxide which are extracted for sale must also be reported in the same manner on the monthly Form 9-361. . . .

The broad authority possessed by the Secretary to determine the appropriate method of calculating transportation allowances has been noted in Shell Oil Company, 52 IBLA 15 (1981) 88 I.D. 1, which states, in part:

. . . The Secretary of the Interior has discretionary authority to determine the factors to be considered in computing transportation allowances for royalty valuation purposes. . . .

The Conservation Division Manual (CDM), a procedural guide of the U.S. Geological Survey (USGS), predecessor agency to MMS, addresses transportation allowance guidelines. The CDM Part 647.5.3E (1974), titled, "Approval of Transportation Allowances," addresses the maximum allowable transportation allowance and states, in part:

. . . However, when the transportation cost is greater than 25 percent of the fair market value at the nearest competitive sales terminal, the Supervisor must conduct a complete review prior to approval of such rates. Under no circumstances should transportation costs exceed 50 percent of the product's fair market value at the nearest competitive sales point. . . . [Emphasis added.]

In addition, the Federal regulations effective March 1, 1988, 30 CFR § 206.156(c)(1) (1989), titled, "Transportation allowances-general," states, in part:

. . . for unprocessed gas valued in accordance with § 206.152 of this subpart, the transportation allowance deduction on the basis of a selling arrangement shall not exceed 50 percent of the value of the unprocessed gas . . .

SWEPI has incorrectly calculated its SWEPI, Chevron, and Total Unit weighted average prices, for the period January 1, 1984, through September 30, 1989. This has resulted, because of four contract pricing errors (four separate deliveries) and by exceeding the transportation deduction limitation of 50 percent of unit value (10 separate deliveries). The contract pricing and transportation issues will be elaborated below:

Denver Unit In-Kind Delivery Meter 74222-5008

The State has determined that the applicable price for this delivery should be the contract dated January 1, 1982, between ~~_____~~ X-4 ~~_____~~ X-4 (determined to be an arm's-length contract by the Royalty Valuation and Standards Division (RVSD), MMS). This contract is considered to be the unit operator's principal CO₂ purchase contract as it accounts for approximately 60 percent of the total CO₂ delivered to the Denver Unit.

The MMS disagrees with SWEPI's contention that the time factor is controlling when determining comparable arm's-length contracts in valuing production, subject to royalty, sold under non-arm's-length situations. The State's analysis of the referenced contract as the principal CO₂ contract concludes that it meets the criteria set out in 30 CFR §§ 206.103 and 206.152(c)(1). The comparable contract applied by the State had the following attributes consistent with Federal regulations: the highest price; effective for the same production periods; the CO₂ was from the same source fields (McElmo Dome Unit Production); accounted for the majority of the CO₂ consumed at the Denver Unit (60 percent); and finally, it is consistent with past RVSD determinations.

The determination by RVSD that the January 1, 1982, contract contained pricing provisions acceptable in establishing a value for royalty purposes, was supported based on the fact that an arm's-length contract between X-4 X-4 dated March 1, 1983, covered sales of CO₂ from the McElmo Dome Unit indirectly to the Denver Unit and the pricing provisions of this arms-length contract were almost identical to the X-4 contract of January 1, 1982. SWEPI's contention that the July 1, 1986, contract should be the principal CO₂ contract is incorrect. The July 1, 1986, contract is a non-arm's-length contract and covers less than 20 percent of the requirement to the Denver Unit. In addition, it was executed after the date of the CO₂ in-kind agreement that is being valued. There were no arm's-length contracts covering sales to the Denver Unit other than the X-4 contract referenced above during the audit period.

Wasson ODC In-Kind Delivery Meter 74222-502A

The State has determined that the applicable price for this delivery should be the contract dated November 1, 1984, between X-4 _____ and the seller, X-4 (determined to be an arm's-length contract by RVSD). This contract is considered to be the unit operator's principal CO₂ purchase contract, as it accounts for approximately 63 percent of the total Unit's CO₂ requirement.

The MMS again disagrees with SWEPI's contention that the time factor is controlling when determining comparable arm's-length contracts in valuing production, subject to royalty, sold under non-arm's-length situations. The State's analysis of the referenced contract as the principal CO₂ contract concludes that it meets the criteria set out in 30 CFR §§ 206.103 and 206.152(c)(1). The comparable contract applied by the State had the following attributes consistent with Federal regulations: the highest price; executed in the same period (both executed November 1, 1984); effective for the same production periods; accounted for the majority of the CO₂ consumed at the Wasson ODC Unit (63 percent); and finally, it is consistent with past RVSD determinations.

It should also be noted that although SWEPI's choice for a comparable contract was the contract executed on November 17, 1984, no deliveries took place until April 1985. SWEPI did not begin to apply the — X-4 — contract, to the in-kind deliveries, until April 1985. Whereas, the SWEPI in-kind deliveries to meter 74222-502A began in November 1984, and was coincidentally valued in accordance with the November 1, 1984, X-4 contract. The periods at issue for this delivery are April 1985 through March 1986 and July 1986.

South Wasson Clearfork In-Kind Delivery Meter 74222-509

SWEPI failed to include the correct tariff reimbursement pricing terms. The contract for valuing this delivery is dated June 30, 1986, between X-4 _____ X-4 _____. The price terms, addressing the transportation reimbursement, states, in part:

. . . Buyer agrees to reimburse seller for a transportation charge, F.O.B. Denver City, Texas as set out below: Tariff reimbursement of \$X-4 (1986), \$X-4 (1987), \$X-4 (1988) and \$X-4 (1989) . . .

SWEPI improperly utilized a transportation reimbursement of \$0.39; the amount of the Cortez tariff.

McElmo Creek Third Party Meter 74236-FM2

The applicable contract for valuing this delivery is the contract dated July 12, 1985, between _____ X-4 _____ SWEPI has failed to properly convert the price to the contract stated pressure base of X-4 psia.

TRANSPORTATION DEDUCTION LIMITATION

SWEPI has incorrectly taken transportation deductions, exceeding 50 percent of the product's unit value, on ten separate deliveries. As previously mentioned, the CDM, Part 647.5.3E., and 30 CFR § 206.156(c)(1), state that under no circumstances should the transportation cost exceed 50 percent of the product's fair market value.

These price valuation issues all affect the calculation of the SWEPI, Chevron, and Total Unit weighted average prices and have resulted in SWEPI underpaying royalties by \$827,677.46. (See Exhibit B Schedules.)

ROYALTY ON SEVERANCE TAX REIMBURSEMENTS

Federal regulations and instructions from MMS establish the value to be used in calculating royalties due from Federal leases. Title 30 CFR § 206.103 (as previously cited), which applies to the period December 1, 1983, through February 29, 1988, and 30 CFR 206.152(h) (1988), effective March 1, 1988, states, in part, that royalty is due on the ". . . gross proceeds accruing to the lessee. . . ."

Further support is cited in Section III of NTL-1, which states, in part:

. . . Under no circumstances will the royalty value be computed on less than the gross proceeds accruing to the operator from the sale of such leasehold production. Gross proceeds include, but are not limited to, tax reimbursements and payments to the operator for gathering, measuring, compressing, dehydrating, or performing other services necessary to market the production [Emphasis added.]

In addition, MMS' position on tax reimbursements has been upheld in court in Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

Furthermore, the CO₂ purchase contracts used to value the deliveries to meters 74221-501 and 502, dated November 19, 1984, and November 19, 1987, between —X— —4— respectively, state, in part:

. . . Buyer shall, subject to the conditions hereinafter set forth, pay Seller X — 4 of any additional tax. The term "additional tax" shall mean any sales, transaction, occupation, service, production, severance, gathering, transmission, value-added or excise tax, assessment of fee levied, assessed or fixed by governmental authority and taxes of a similar nature or equivalent in effect (not including income, excess profits, capital stock, franchise or general property taxes) in respect of or applicable to the carbon dioxide delivered hereunder to Buyer in addition to or greater than those, if any, being levied, assessed or fixed on October 1, 1984, and for which Seller may be liable, either directly or indirectly, or through any obligation to reimburse others. . . .

The State's review determined that the contracts used to value the CO₂ deliveries analyzed, contained similar language as that cited above. Detailed below are the unique elements of the tax reimbursement terms in each of the contracts as incorporated by the State in its valuation of the deliveries.

<u>CO. PURCHASE CONTRACT USED TO VALUE DELIVERIES</u>	<u>METER NUMBER(S)</u>	<u>DELIVERIES MADE TO</u>	<u>CONTRACT TERMS FOR TAX REIMBURSEMENTS</u>
January 1, 1982 X — 4	74222-500A	Denver Unit	X — 4 of any additional tax as of the date of the contract.
November 1, 1984 / — 4	74222-502A	Wasson ODC Unit	X — 4 of increased tax after 1/1/83, and/or X — 4 of all new taxes imposed after 6/1/84.
November 17, 1984 ✓ — 4	74222-502B	Wasson ODC Unit	X — 4 of any additional tax beginning 3/1/84.
July 12, 1985 X — 4	74236-FM2	McElmo Creek Unit	X — 4 of any additional tax beginning 3/15/84.
March 1, 1988 X — 4	74221-509A 74221-509B	South Cross Field	X — 4 of any additional tax beginning 9/1/87.

The State has determined that SWEPI is entitled to receive severance tax reimbursements on the contracts listed above. This is a result of the severance taxes on the McElmo Dome Unit production increasing above and beyond the base period tax. Therefore, SWEPI has underpaid royalties by \$80,953.89 as a result of not including severance tax reimbursements in their royalty calculations. The total royalties due per this order is higher than the amount given in the State's preliminary letter of \$70,214.54. This difference comes about through revisions to the royalty computation schedules correcting addition errors. (See Revised Exhibit C Schedules.)

In order to bring royalty payments for the referenced leases into compliance with the Federal regulations cited above, NTL-1, the CDM, and lease terms, SWEPI is directed to pay the additional royalties due of \$908,631.35 as

presented on the enclosed computation schedules. Payment must be mailed to the address indicated on the enclosed bill, must be made payable to the U.S. Department of the Interior, MMS, and must be received by the invoice due date.

To insure proper credit to your account, please include with your payment the remittance copy of the Bill for Collection and completed green Forms MMS-2014 using adjustment reason codes 40 and 42 as applicable. Appropriate late payment charges pursuant to 30 CFR § 218.102 (1991) will be computed and billed to SWEPI upon receipt of payment of the additional royalties due.

Section 109 of FOGRMA, promulgated in 30 CFR § 241.51 (1991), authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order, lease, or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR § 241.51(a)(3) and could subject you to penalties of up to \$5,000 per violation per day for each day such violation continues.

You have the right to appeal in accordance with the provisions of 30 CFR 290 (1991). Any appeal taken will be to the Director, MMS, and the notice of appeal must be filed within 30 days from the date of receipt of this letter with:

Mr. David S. Guzy, Chief
Office of State and Tribal Program Support
Royalty Compliance Division
Minerals Management Service
P.O. Box 25165, Mail Stop 3601
Denver, Colorado 80225-0165

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. With the exception of the time fixed for filing a notice of appeal, the time for filing any document in connection with an appeal may be extended by the Director, MMS. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR § 243.2 (1991), compliance with this order will be suspended upon posting of an adequate surety in the form of a bond or letter of credit pending the outcome of the appeal. The surety must be received at MMS by the invoice due date. The surety must be in the amount of \$1,638,000, which includes the principal plus interest that will accrue through August 31, 1993. Upon request by MMS, the surety will be increased periodically, if necessary, to cover any additional interest that may accrue. Enclosed are instructions for posting surety including MMS address for mailing the surety.

Mr. Lee Hileman

11

If you should have any questions concerning this matter, please call
Mr. Mike Santos of the Colorado Department of Revenue at (303) 294-5140, or
Mr. Patrick Milano of MMS at (303) 969-6659.

Sincerely,

Original Signed

David S. Guzy

David S. Guzy, Chief
Office of State and Tribal
Program Support

Enclosures

Enclosure 1 -

Exhibit A - Colorado Federal Leases Reviewed

Enclosure 2 -

Exhibit B - CO₂ Price Valuation Computation Schedules

Enclosure 3 -

Exhibit C - Revised Tax Reimbursements Computation Schedules

Enclosure 4 - Posting Surety Instructions

Enclosure 5 - Forms MMS 2014

~~cc: R. Fees, State of California~~

R. Fees, State of California

S. Miller, State of Louisiana

D. Hoffman, State of Montana

G. Staigle, State of North Dakota

M. Dunn, State of Texas

J. Fodge, State of Oklahoma

Area Manager, HACO

RCD Chron

RCD/STP File

RCD/STP Chron

RCD:OSTPS:MS3601:JClark:dvh:4/28/92:FTS321-6660:STP:2-4-87

Final:dvh:7/17.92

SHELL OIL COMPANY
BUSINESS PROCESSING
P. O. BOX 4655
HOUSTON, TX 77210-4655

February 4, 1992

Mr. F. David Loomis, Manager
Mineral Audit Section
Colorado Department of Revenue
999 Eighteenth Street
Suite 1025, North Tower
Denver, CO 80202

RECEIVED

FEB 06 1992

COLORADO DEPT OF REVENUE
MINERAL AUDIT

SUBJECT: COLORADO DEPARTMENT OF REVENUE
ROYALTY AUDIT OF FEDERAL LEASES
MC ELMO DOME UNIT
DELORES AND MONTEZUMA COUNTIES, COLORADO

Dear Mr. Loomis:

Shell Oil Company, on behalf of Shell Western E&P Inc. ("SWEPI"), has reviewed your preliminary determination of royalty underpayment by SWEPI on federal leases in the McElmo Dome Unit for the audit period December 1, 1983 through September 30, 1989. Thank you for the extension of the time to respond from January 21, 1992 until February 6, 1992.

Section 2415(a) of Title 28, United States Code, provides for a six-year limitations period with respect to federal actions for money damages. This statute is applicable to claims for royalty on federal leases and begins to run when the royalty was due or paid. *Phillips Petroleum Co. v. Manuel Lujan, Secretary of the Department of the Interior*, (N.D. Okla., October 18, 1989); appeal docketed, No. 90-5122, 10th Circuit, June 29, 1990. The filing of the audit letter dated July 18, 1990 does not halt the running of the six-year statute of limitations. Thus, it will be SWEPI's contention if a demand letter for underpayment of royalties is issued with respect to the McElmo Dome Unit that the applicable audit period cannot extend beyond six years from the date of such demand letter.

Conservation Division Manual (CDM) § 647.5.3E and the Code of Federal Regulations 30 CFR § 206.156(c)(1), state that under no circumstances should the transportation cost exceed 50 percent of the products' fair market value. SWEPI, in the past, has not requested an exception to this regulation and SWEPI concedes this statement is correctly applied to this particular audit. However, we reserve the right to petition for an exception to this regulation. If an exception is granted, it might be retroactively applied and we will recoup both principal and interest for all affected areas of this audit.

SWEPI's acquiescence to any of your preliminary findings does not preclude us from invoking the six-year statute of limitations or

requesting an exception to the 50% limitation for transportation deduction.

As a result of SWEPI's review of your preliminary determination letter, SWEPI agrees with your findings concerning the South Wasson Clearfork In-kind Delivery Meter 74222-509, the McElmo Creek Third Party Meter 74236-FM2, the transportation deduction limitation, and the royalty on severance tax reimbursements. SWEPI disagrees with your determination of royalty underpayments with respect to the Denver Unit in-kind delivery meter 74222-500B, and the Wasson ODC Unit in-kind delivery meter 74222-502A as follows:

DENVER UNIT IN-KIND DELIVERY METER 74222-500B

SWEPI disagrees with the contention of the Colorado Department of Revenue (CDR) that the applicable price for royalty purposes for this in-kind delivery of CO₂ by SWEPI to the Denver Unit should be based on the price established by the January 1, 1982 contract for the sale of CO₂ by ~~_____~~ X-4 ~~_____~~ to the Denver Unit. As the CDR recognizes, the January 1, 1982 contract was determined by the MMS on September 10, 1984 to be acceptable for establishing a value for royalty purposes. We believe that the same reasons that the MMS found the January 1, 1982 contract to be an arm's length contract for valuing royalty exist and apply with respect to the July 1, 1986 contract for sale of CO₂ to the Denver Unit. In other words, the July 1, 1986 contract is also an arm's-length contract negotiated in the same manner as the January 1, 1982 contract. SWEPI's share of the CO₂ delivered under the July 1, 1986 contract should be valued based on the terms of such contract. The facts surrounding the implementation of the July 1, 1986 contract are as follows: Conoco, the second largest working interest owner in the Denver Unit, by letter dated November 6, 1985, requested SWEPI, operator of the Denver Unit, to renegotiate the January 1, 1982 contract to permit the Denver Unit working interest owners to obtain a more competitive price for CO₂ than currently existed under the January 1, 1982 contract. On January 23, 1986, SWEPI balloted the Denver Unit working interest owners on this matter (Attachment No. 1). The Denver Unit working interest owners directed SWEPI to limit CO₂ purchases under the January 1, 1982 to the take-or-pay volume (~~X-4~~ MCF/d) and to negotiate a new sales contract and/or supply in-kind contracts for the required CO₂ in excess of the take-or-pay volume. A bid letter dated March 31, 1986, developed by Conoco and Texaco on behalf of the Denver Unit, was sent by SWEPI, as operator, to potential CO₂ suppliers (Mobil, Amoco, Exxon, ARCO, and SWEPI) (Attachment No. 2). Only X-4 and X-4 submitted bids to supply the Denver Unit. By letter dated June 2, 1986, Conoco and Texaco acting as administrators of the Denver Unit CO₂ supply proposal, recommended that negotiations should be conducted with respect to ~~X-4~~ offer of May 9, 1986 (Attachment No. 3). Such negotiations resulted in the July 1, 1986 contract.

The federal royalty valuation regulations effective in 1986 provided that the value of production shall be the estimated

reasonable value of the product. In the absence of good reason to the contrary, value computed on the basis of the highest price per MCF paid at the time of the production in a fair and open market for the major portion of like-quality gas produced and sold for the field where the leased lands are situated was considered to be reasonable value (30 CFR § 206.103 (1985)). The CDR has focused its determination solely on the price at which the major portion of the CO₂ is sold to the Denver Unit. In so doing, the CDR has failed to recognize that the federal regulations also refer to time of production as a factor. The 1982 contract was negotiated at a time of high oil prices while the 1986 contract reflected the swift decline in oil prices. Such decline in the price of oil reduced the number of tertiary recovery projects being implemented and thus reduced the demand for CO₂. As a result, the value of CO₂ was much less in 1986 than in 1982. The major portion of the gas sold in 1986 was on the same terms as those that X-4 based its in-kind deliveries.

In March 1988, when the federal royalty valuation regulations were revised, SWEPI's valuation of its in-kind deliveries remained proper. If the 1986 contract was recognized as an arm's-length contract, the value of the gas would be the gross proceeds accruing to the lessee. This is the value at which all other suppliers of CO₂ to the Denver Unit would be entitled to use for royalty purposes. If the in-kind deliveries by SWEPI are considered as disposition of gas other than by arm's-length contract, the gross proceeds accruing to the lessee are still the value of the gas for royalty purposes, provided such gross proceeds are equivalent to gross proceeds paid under comparable arm's-length contracts for sales of like quality gas in the same field. Again, one of the factors to be considered in evaluating the comparability of such contracts is the time of execution of the contract. The sale of CO₂ by X-4 to the Denver Unit in 1986 is the comparable arm's-length contract for determination of the value of in-kind deliveries. Therefore, SWEPI's determination of royalty due is correct.

WASSON ODC IN-KIND DELIVERY METER 74222-502A

SWEPI disagrees with the contention of the CDR that SWEPI's in-kind deliveries to the Wasson ODC Unit should have been valued on the basis of the ~~X-4~~ contract that accounted for nearly 63 percent of the unit's CO₂ requirement.

The CDR has focused solely on the price at which the major portions of the CO₂ were sold in making its determination that such price constitutes the reasonable value of the CO₂ for in-kind deliveries.

SWEPI entered into an arm's length contract with X-4, dated November 17, 1984, to sell CO₂ from the McElmo Dome Unit at a commodity price of X-4 per MCF to be adjusted quarterly based on crude oil postings of various producers in the Wasson Field. Contemporaneously with such arm's-length contract, SWEPI entered into an in-kind contract with X-4 with respect to

its X - 4 percent interest in the Wasson ODC Unit. SWEPI considered the reasonable value of such in-kind delivery to be the arm's length price that it had simultaneously negotiated for the sale of CO₂ to X - 4. The CO₂ sold to X - 4 was used by X - 4 as its in-kind delivery to the Wasson ODC Unit. Subsequently in 1989, SWEPI entered into a new in-kind delivery contract with X - 4 for the Wasson ODC Unit and SWEPI valued its share of CO₂ at the X - 4 contract price since such contract was the comparable arm's-length contract in effect at the time of execution of the in-kind delivery contract.

The federal royalty valuation regulations provide that value computed on the basis of the highest price per MCF paid at the time of production in a fair and open market for the majority of the like quality gas produced and sold from the field when the federal leases are located will be considered to be reasonable value (30 CFR § 206.103 (1985)).

The November 17, 1984 contract price with X - 4 was arrived at in a fair and open market. The CO₂ sold to X - 4 was produced and sold from the McElmo Dome Unit and was the same CO₂ as was being delivered by SWEPI pursuant to its in-kind deliveries. SWEPI contends that the X - 4 contract was a reasonable price for royalty purposes under the circumstances.

Based on the preceding comments SWEPI respectfully requests the CDR to revise its preliminary determination of underpaid royalties at the McElmo Dome Unit federal leases accordingly. Please direct all correspondence or inquiries to:

Shell Oil Company
ATTN: Lee Hileman
Room 2150A, Smith Bldg
P. O. Box 4655
Houston, TX 77210-4655
(713) 241-9026

We would appreciate your reply to the above disputed items by March 15, 1992.

Very truly yours,

T. W. Fales

T. W. Fales
T. W. Fales, Manager
Production Processing - East
Business Processing
On behalf of Shell Western E&P Inc.

WGR/RLH:NC