

January 27, 1998

Subject: Reporting options and methods to address imbalances for the Wyoming crude RIK pilot

MMS is the federal agency responsible for management of federal offshore minerals development and the collection of minerals revenues associated with federal and Indian onshore lands. It is proposing to collect some of its royalty in kind instead of in value. We have the following comments and concerns relating to this program:

Assumptions

1. We will comply with FOGRMA:
The Royalty Management Act of 1982 (FOGRMA), section 105(a) mandates;
() signifies current method of compliance:
 - a) description of payment (transaction code)
 - b) period covered (sales month)
 - c) source of payment (lease number)
 - d) production amounts (sales volume, royalty quantity)
 - e) royalty rate (calculated)
 - f) unit value (calculated); (quality measurement)
 - g) such other data as agreed upon by the Secretary and recipient

2. We will comply with the regulations:
30 CFR Ch. II (7-1-97 Edition)
 - a) Part 210.52 Report of sales and royalty remittance. A completed Report of Sales and Royalty Remittance (Form MMS-2014) must accompany all payments to MMS for royalties and, where specified, for rents on nonproducing leases.
 - b) Part 210.203 Special forms and reports. The MMS may require submission of additional information on special forms or reports. When special forms or reports other than those referred to in this subpart are necessary, instructions for the filing of such forms will be given by MMS.
 - c) Part 216.50 Monthly report of operations. Each operator of each onshore Federal or Indian lease or agreement containing at least one well not permanently plugged and abandoned shall file a Monthly Report of Operations (Form MMS-3160) unless production data is authorized to be reported on Form MMS-4054 (OGOR).
 - d) Under RSFA, payor required to report working interest owners.

3. Government is paid on entitlements.

4. Existing computer processes are used.

Process Options for Wyoming RIK:

1. MMS bills the refiner based on data reported on OGOR's/Forms MMS-3160. MMS bills based on entitlements; no MMS-2014 prepared by lessees. When the refiner pays their bill, doesn't a MMS-2014 still need to be submitted? How else is MMS going to keep track of what was paid and what wasn't? Money issued to the states and Indians would be delayed, since MMS wouldn't receive any monies until after the OGOR or mmsd-3160 is processed and until after the refiner pays the bill. How are we going to handle discrepancies if the refiner disagrees to amount that they were billed?
2. Lessee reports based on the refiner's allocated share of production at the FMP (hereinafter referred to as deliveries). Lessee reports based on the refiner's allocated share of production at the FMP. Lessees report on MMS-2014 - file OGOR/3160. If the Lessee reports the MMS-2014 and the refiner pays the check, how is MMS going to reconcile any differences? A check without a mms-2014 would make reconciliation difficult at best since the check is based on volume, royalty rate, transportation costs and value.
3. Refiner reports and pays based on entitlements. Lessee reports entitled volumes to refiner; refiner reports on 2014 entitlements. This option would require lessees to report entitled volumes to the refiner. Without the government doing some kind of production verification, what incentive is there for the lessee to dispute the volumes that the refiner says they received?
4. Status quo with delivery point at or near the lease. Lessee reports on 2014 - delivery point at or near the lease - MMS bills refiner based on 2014. Volume balancing would not necessarily be accomplished by simply changing delivery points where feasible and possible. If we receive royalty dollars based on a different delivery point other than the one nearest the lease, aren't we just changing the unit price of the product?
5. Refiner reports and pays based on deliveries with the delivery point at or near the lease
 - a) Refiner reports the bulk volumes delivered at the FMP without respect to property allocation;
 - b) Refiner reports volumes allocated to properties (i.e., accounting identification numbers);
 - c) MMS bills the refiner based on Offshore Minerals Management's (OMM) Liquid Verification System (LVS) production volumes.

Option 5 is the preferred option recommended by the Oil RIK Study Team (September 9, 1997)

Accounting and Reporting

1. Existing and Recommended Method:
 - a) Operators fill out the MMS-3160 or OGOR. All options have lessees filling out the mms-3160/OGOR.
 - b) Payors fill out the MMS-2014 and pay royalties. Fields on MMS-2014:
 - Royalty reporting elements
 - AID (lease no. & revenue source)
 - prod. Code
 - Reg. Price code (not used)
 - selling arrangement

- sales month
 - trans code
 - adj. reason code
 - sales quantity
 - quality measure
 - calc. Method, only used for gas
 - sales value
 - royalty quantity
 - royalty value
 - payment method
- c) Distribution of monies by MMS
- d) If there is an under exception MMS sends:
- e) Initial operator letter
- Notifies operator when AFS/PAAS comparison identifies a valid discrepancy.
 - Request verification of volume and disposition and allocation of product to responsible payor.
 - Existing systems analyze the exception and automatically send out the operator letter.
- f) Initial payor letter
- Identifies actual volume and expected payor volume as identified by operator.
 - Requests an explanation of the payor-reported volume
- g) Order to comply letter or Bill the payor.
- Used when no response or no action is taken
 - Asks for confirmation and explanation of the sales or transfer volumes
 - Ask for date corrections will be submitted.
- h) Notice of noncompliance
- Failure to comply with AFS/PAAS Letters and orders to comply
 - \$500 per day violation
 - After 41 days up to \$5,000 per violation for each day violation continues
 - Working interest owner is the ultimate responsible party for royalty differences.
- i) Notice for knowing or willful violation.
- Failure to report and pay royalties on Federal/ Indian properties identified by AFS/PAAS letters and orders to comply
 - Liable for a penalty of up to \$10,000 per violation for each day such violation continues.
- j) MMS audits companies for final verification of proper royalty payments.
2. One way to properly account for the RIK sales is to have the purchaser report the volumes purchased, API gravity and value on the MMS-2014. If the RIK purchaser reports on the MMS-2014 then the AFS/PAAS comparisons work properly, and MMS can bill the operator/payor for any volumes undertaken by the RIK purchaser. It does not work to have the operators report these volumes as there are no dollars associated with this reporting. If the purchaser doesn't fill out the 2014, then there is no way that we would be able to determine that we received the proper royalties.
3. If the states and small independent producers join our RIK program, we will need a report that allocates the volumes, API gravity and value to each producer. Since we don't get royalties for their share, we can't use a MMS_2014. One solution would let the states work out there own differences with the purchaser.

4. Transportation could change monthly depending on where the purchaser is located.
5. Revenue neutral reporting. We could end up with wrong conclusions if the MMS-2014 has the wrong price listed for value leases for comparison. Are we going to do some kind of comparisons with published prices to see if the price on the MMS-2014 is reasonable? There are lots of trading agreements that go on which could make the reported price too low compared to the price after auditing.
6. For comparability purposes the RJK and value leases and agreements should be located side by side. The oil needs to be of comparable quality (sulfur content, API gravity and type of crude (Paraffin, Paraffin-intermediate, Intermediate-paraffin, Intermediate, Intermediate-naphthene, Naphthene-intermediate or Naphthene). Sulfur content and API gravity are the two properties which have the greatest influence on the value of the crude oil. Normally, 0.5 percent sulfur content is the dividing line between sweet and sour crude.

Questions:

1. Who pays if the refiner and operator disagree as to how much oil was delivered? Are we going to do this on a monthly basis or wait for some period like 6 months or a year and then send a bill at the end of the time period. Since the value will change monthly, wouldn't we still have to compute the bill on a monthly basis even if we wait for six months to a year to bill the operator?
2. What if the volume is correct but the API gravity or unit price is in question? Do we bill the lease operator or the refiner? It seems to us that we would bill the operator.
3. Do we need to know if the crude is sweet or sour, shipped by truck or piped?
4. What about trading agreements? Will these change the transportation tariff point? If the selling point changes from month to month, the tariff point will change.
5. With value, operators pay for pipeline losses, meter differences or balancing agreements. If we take the oil down stream from the royalty meter, do we share all losses with the operator? Will the increased unit price be high enough down stream to offset the risk of volume losses?
6. Since we don't have any tank storage, can we assume that first production is the royalty portion?
7. The refiner will have a blend of oil from many sources. Will we have enough information to allocate the proper amount of RJK oil to the proper leases? What about the API gravity bank? In order to come up with the correct price, the API gravity, crude type, sulfur content, and tariff correction are needed. Won't this be done on a weighted allocation based on royalty measurement?