Sales to Affiliates: Gas, Oil & Coal

Purpose

To provide you with information and guidance on how to value Non-Arm's-Length [NAL] sales of oil, gas and coal from Federal and Indian lands. You will demonstrate the skills learned by working exercises and a case study, individually and in groups.

Definitions

Lessee: Any person to whom the U.S. or a tribe or an Indian owner issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

Definitions

Lessee: This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility.

Definitions

Marketing Affiliate – An affiliate of the lessee whose function is to acquire only the lessee's production and to market that production.

(This definition does not apply to coal.)

Definitions

Affiliate – Corporations/organizations which are related either as (1) parent and subsidiary, or as (2) subsidiaries of the same parent organization.

Definitions

Affiliate – If the lessee transfers or sells production to an affiliate that also buys production from other sources, that affiliate is not a marketing affiliate.

Definitions

Arm's-Length [AL] – Contract arrived at in the market place between independent, non-affiliated persons with opposing economic interests.

- Ownership > 50% Control
- Ownership = 10% - 50% Assume Non-control*
- Ownership < 10% Assume Non-control

* The regulations say that, in cases where ownership is between 10 – 50%, we should presume control, but this has been changed by the National Mining Association decision, discussed on the following slides.

Definitions

- Guidance issued in light of the National Mining Association decision provides other factors to consider to determine whether there is control in situations where ownership is between 10 and 50 %.

National Mining Association, Appellant, v. United States Department of the Interior, et al., 177 F3d 1 (D. C. Cir., 1999)

Definitions

- Factors to be considered include:
  - The extent to which there are common officers or directors
  - The percentage of ownership and relative percentage of ownership of voting securities or other instruments of ownership
  - Operation of a lease, plant, or other facility or the extent of participation in management or operation
  - Other evidence of power to exercise control

Definitions

- Regardless of any percentage of ownership or common ownership, relatives, either by blood or marriage, are affiliates.

Definitions

Gross Proceeds – The value of production for royalty purposes shall never be less than the gross proceeds accruing to the lessee.

Definitions

Gross Proceeds:

Includes reimbursements for:

- Taxes
- Production related costs
- Certain services [dehydration, sweetening, marketing]
- Detail applicable to coal is found on slides 83 - 88

Definitions

Sale – A contract between two persons (parties) where:

- the seller unconditionally transfers title to the production to the buyer
- the buyer pays money or other consideration for the sale
- the parties' intent is for a sale to occur

Definitions

Marketable Condition – means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.

Definitions

Marketable Condition – (Cont'd)

Normal requirements – lessee must meet pressure and quality (Btu, moisture, H2S, CO2) requirements.

Definitions

Spot sales agreement –

"…a contract wherein a seller agrees to sell to a buyer a specified amount of unprocessed gas, residue gas, or gas plant products at a specified price over a fixed period, usually of short duration, which does not normally require a cancellation notice to terminate, and which does not contain an obligation, nor imply an intent, to continue in subsequent periods."

(underlining added)

from 30 CFR § 206.151 (2003)

Marketable Condition and Duty to Market

The lessee must place production in marketable condition and market the production for the mutual benefit of the lessee and the lessor at no cost to the Federal Government or Indian lessor, unless otherwise provided in the lease agreement.

Marketable Condition and Duty to Market

Where the value is determined by a lessee's gross proceeds, that value will be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the production in marketable condition or to market the production.

Valuation Guidance

Fina Court Decision

- Value gas sold to non-marketing affiliates based on the first applicable benchmark.
- The court overturned a portion of the Texaco decision (MMS-92-0306-O&G), which held that gross proceeds were based on the non-marketing affiliate's first arm's-length resale.

Valuation Guidance

"If the affiliate of the lessee also purchases gas from other sources, then that affiliate presumably will have comparable arm's-length contracts with the other parties which should demonstrate the acceptability of the gross proceeds accruing to the lessee from its affiliate." (from the preamble to the 1988 gas valuation rule, *Federal Register*, Vol. 53, No. 10, January 15, 1988)

Valuation Guidance

- Xeno inc, IBLA 92-501, 11/14/1995

  Gross proceeds

- IBLA 91-266

  Gross proceeds and access to records of an affiliate

Valuation Guidance

- IBLA 90-509, 9/28/1993

  Santa Fe Energy Products Co.

  Affiliate Sales

- Tenth Circuit Court of Appeals No. 95-1221, 4/10/1996

  Santa Fe Energy Products Co.

  Records of the affiliates

- IBLA 87-762, 88-56, 8/29/1989

  Conoco, Arco

  Floor value for determining fair market value

Federal Valuation Guidance – Gas

Regulatory Authority

- 30 CFR § 206.152 (c) and (h) (2003) establishes value for unprocessed gas sold under NAL contracts.
  - The value shall be the reasonable value determined under the first applicable benchmark, but not less than gross proceeds.
- 30 CFR § 206.153 (c) and (h) (2003) establishes value for processed gas sold under NAL contracts.
  - The value shall be the reasonable value determined under the first applicable benchmark, but not less than gross proceeds.

Federal Valuation Guidance – Unprocessed Gas

- First Benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable AL contracts.
- Second Benchmark: The gross proceeds determined under AL contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in AL spot sales of gas, other reliable public sources of price or market information, and other information relative to the particular lease operation or the saleability of the gas.
- Third Benchmark: Net-back method or other reasonable valuation method.

Federal Valuation Guidance – Processed Gas

- First Benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable AL contracts.
- Second Benchmark: The gross proceeds determined under AL contracts for like-quality residue gas or gas plant products **from the same gas plant or other nearby processing plants**, posted prices, prices received in AL spot sales of **residue gas or gas plant products**, other reliable public sources of price or market information, and other information relative to the particular lease operation or the saleability of the **residue gas or gas plant products.**
- Third Benchmark: Net-back method or other reasonable valuation method.

Benchmark One - Gas

- First Benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable AL contracts in the field or area.
  - Use the most comparable AL contract to determine value
  - Compare the lessee's NAL gross proceeds to the AL gross proceeds in the field or area. If the NAL gross proceeds are greater than or equal to comparable AL gross proceeds, then accept the NAL gross proceeds.

Benchmark One - Gas

Determine value using two criteria: equivalency of gross proceeds and comparability of AL contracts

- Equivalency: NAL contract gross proceeds are not less than the most comparable AL contract gross proceeds
- Comparability: Utilize the following screening criteria or factors
  - Price – Components of the contract price (transportation factors, marketing costs, etc.)
  - Duration – Contract period

Benchmark One - Gas

- Comparability (Cont'd)
  - Market(s) served, or point of sale
  - Terms – for example, conventional vs. percentage of proceeds contract, or long-term vs. short-term
  - Quality – methane content (mole %), NGL content, non-hydrocarbon gas content (hydrogen sulfide, CO2, etc.)
  - Volume – delivered quantity
  - Other appropriate factors – any factors unique to a particular audit/compliance situation
- Comparability is unique to each audit/compliance review

Benchmark One - Gas

Comparability of terms involves consideration of contract duration, whether short-term or long-term. While we cannot define either of these terms precisely, generally short-term is less than a year and long-term is a year or longer. Spot sales contracts are generally considered short-term (see slide 17 for a definition of spot sales agreement).

Benchmark One - Gas

Example of Comparability Factors – Price

Production: 200,000 Mcf ; Contract NAL; Contract term is similar to other AL long-term contracts.

Price $ 3.79

Purchaser/Seller	Mcf	Contract	Price($)
A & R Corp	200,000	Spot	3.65
BW Gas Inc	413,000	AL	5.41*
Cad Energy	185,000	AL	5.29
Tee Corp	359,000	AL	5.68*
JW Petroleum	10,000	AL	5.27

*Contracts include a transportation fee

Benchmark One - Gas

Example of Comparability Factors: Price

Solution:

- A & R Corp contract is not comparable as it's a spot sale rather than a long-term contract.
- The Cad Energy contract represents the most comparable well head sale and price in the field.
- The BW Gas and Tee Corp contracts are not for well head sales.
- The JW contract is not for comparable quantities.

Benchmark One - Gas

Example of Factors – Duration

Production month: July 2001; 200,000 Mcf ; contract NAL; 4 year term; Effective 1/1/2000 – 1/1/2005; Price: $ 4.29

Purchaser/Seller	Mcf	Contract	Duration	Effective	Price $
A & R Corp	200,000	Spot	1 month	1/7/01	4.20
BW Gas Inc	213,000	AL	1 year	7/1/00	4.29
Cad Energy	255,000	AL	6 years	7/1/96	5.68
Tee Corp	189,000	AL	10 years	5/1/93	5.01
JW Petroleum	239,000	AL	3 years	9/1/98	4.53
Hi Octane Corp	268,000	Spot	3 months	5/1/01	4.23

Which one is the most comparable contract?

Benchmark One - Gas

Example of Comparability Factors: Duration

Solution: JW Petroleum is the most comparable contract and the price is $4.53/Mcf. The Cad Energy and Tee Corp. contracts could also be considered comparable, because they are long-term, but we must settle for the lowest comparable price.

Benchmark One - Gas

Example of Comparability Factors: Like-Quality Gas

Lease: # AAA; Production 150,000 Mcf; Contract NAL; Btu – 1041; Gas Comp - 0.89% Inert gas; NGL % - 2.98; Price/MMBtu $3.99.

Lease	*Production*	*Contract*	*Btu*	*Inert gas%*	*NGL%*	*Price($)*
A	410,000	AL	1034	0.63	2.54	4.19
B	368,000	AL	1407	1.26	28.50	5.17
C	440,000	AL	1321	2.01	22.91	4.88
D	288,000	AL	1047	0.99	3.35	4.65
E	300,000	AL	1281	2.19	20.26	4.27

All Btu at 14.73 psia. Which one of the leases has like quality gas?

Benchmark One – Gas

Example of Comparability Factors: Like-Quality Gas

Solution: Leases A and D could be considered as producing similar quality gas. D is most comparable and is also the higher price. The others have significantly different NGL content. The auditor may need to look at other factors to determine which of these is most comparable.

Benchmark One – Gas

Examples 1, 2 and 3

Benchmark Two - Gas

- Second Benchmark: The gross proceeds determined under AL contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in AL spot sales of gas, other reliable public sources of price or market information, and other information relative to the particular lease operation or the saleability of the gas.
- Used when:
  - Lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable AL contracts, or if
  - No comparable AL contracts exist in the field or area, or if
  - Lessee receives no consideration

Benchmark Two - Gas

- Second Benchmark (cont'd):

  Lessee must consider other relevant information in valuing like-quality gas in the field or area

  - Gross proceeds under AL contracts
  - Published or posted prices
  - AL spot prices
  - Other reliable public sources
  - Any information unique to the property

Benchmark Two - Gas

Examples 4 and 5

Benchmark Three - Gas

- Third Benchmark: A net-back method or any other reasonable valuation method.
  - Determined on a case-by-case basis
  - A net-back method is intended for use primarily where the form of the lease product has changed, and it is necessary to start with the sales price of the changed product and deduct transportation and processing costs.

    (from the preamble to the 1988 gas regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1243.)

Benchmark Three - Gas

Example 6

Audit/Compliance Approach

Audit/Compliance Approach

- Determine the first applicable benchmark value and compare to gross proceeds. Value for royalty purposes is the higher of the two.

Audit/Compliance Approach

- Determine lessee's gross proceeds:
  - Add back any costs deducted for putting the products into marketable condition
  - Add any reimbursement received for costs incurred in putting the products into marketable condition
  - Increase value by any costs incurred by any other party to put the production into marketable condition

Audit/Compliance Approach

- Determine lessee's gross proceeds:
  - Add back any marketing costs deducted from the lessee's gross proceeds
  - Add any reimbursement received for marketing the product.
  - Increase value by costs incurred by any other party to market the production.

Audit/Compliance Approach

- Determine lessee's gross proceeds:
  - Add any tax or other reimbursements

Audit/Compliance Approach

- Access to records
  - Any Federal or Indian lessee will make available upon request to the authorized MMS or State or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.
  - From 30 CFR 52 (e) (2), 102 (d), 152 (e) (2), 153 (e) (2), 172 (e) (2) (1999), 173 (e) (2) (1999)

Special Situations

- NAL POP Contacts
  - Valued as processed gas
  - Value of residue gas and NGLs is based on benchmarks
  - Processing costs are based on the lessee's actual costs to process the gas
  - When the residue gas is sold NAL, accounting for comparison is required

Special Situations

Refer to the Oil and Gas Payor Handbook Volume III, Product Valuation (8/1/2000) on page 4-55 for the following situations.

- Warranty contracts
- Exchange agreements
- Keep-whole agreements
- Residue gas returned to the lease
- Pool pricing

Case Scenario with Court Decisions

Indian Gas

Indian Gas

- Old Regulations: 30 CFR 172-173 (1999)
  - The same benchmarks discussed under Federal gas valuation apply

- New Regulations: 30 CFR 172-173 (2000)
  - Effective January 1, 2000
  - NAL production not in an index zone
    - valued at the higher of NAL gross proceeds, benchmark value or major portion price

Oil Valuation

Oil Valuation

- Regulatory Authority
  - 30 CFR 206.102 (c) Valuation standards for Federal oil (prior to June 1, 2000)
    - The value shall be the reasonable value determined under the first applicable benchmark.
  - 30 CFR 206.52 (c) Valuation standards for Indian oil
    - The value shall be the reasonable value determined under the first applicable benchmark.
  - 30 CFR 206.52 (a) (2) (i) Major Portion requirement may apply to Indian oil
    - MMS will compare the value determined under the benchmarks to the major portion value and the value for royalty purposes shall be the higher of the two.

Oil Valuation
(pre June 2000 for Federal)

- First Benchmark: Lessee's gross proceeds
  - Lessee's contemporaneous posted prices or oil sales contract prices used in AL sales
  - Lessee's price must be:
    - Comparable to other contemporaneous AL prices
    - Used to purchase significant quantities of like-quality oil
    - Used to purchase production in the same field or area

Oil Valuation
(pre June 2000 for Federal)

- First Benchmark:
  - If the lessee buys and/or sells AL at different postings or prices, use volume weighted average price to value production
  - If not, go to the next benchmark

Oil Valuation
(pre June 2000 for Federal)

- Second Benchmark:
  - Arithmetic average of contemporaneous posted prices used in AL transactions by persons other than the lessee.
    - Must be used to purchase:
      - Significant quantities of like-quality oil
      - Production in the same field or area
      - AL purchases (including premiums) by parties other than the lessee
    - Determine significant quantities case-by-case

Oil Valuation
(pre June 2000 for Federal)

- Second Benchmark:
  - Significant Quantities:
  - "…the term significant quantities" is variable depending on the sales volumes from the field and the volume of production. What constitutes significant production from an onshore field may not be significant for an OCS field. Therefore, "significant quantities" will vary case by case. (From the preamble to the 1988 oil valuation regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1202.)

Significant Quantities Example

Significant quantities has no precise definition and depends on the circumstances of a particular field or area.

Happy Canyon Field: Production = 500,000 barrels per month.

Buyer	Quantity	Price ($/Bbl)
Purchaser A	400,000	29.99
Purchaser B	35,000	27.25
Purchaser C	35,000	27.39
Purchaser D	20,000	27.30
Purchaser E	10,000	26.90

Purchaser A buys significant quantities of production from Happy Canyon Field.

Significant Quantities Example

Giant Dome Field: Field produces 100,000 barrels per month.

Buyer	Quantity	Price ($/Bbl)
Purchaser A	1,000	26.90
Purchaser B	5,000	27.00
Purchaser C	15,000	27.20
Purchaser D	18,000	27.25
Purchaser E	22,000	27.30
Purchaser F	25,000	27.30
Purchaser G	14,000	27.20

Purchaser A does not buy significant quantities of crude oil from Giant Dome field. Purchasers C, D, E, F & G are the ones who buy significant quantities of production from this field.

Note: The significant quantities of oil production in one field may be insignificant quantities of oil production in another field as shown in this example.

Oil Valuation
(pre June 2000 for Federal)

- Second Benchmark:
  - Example of Significant Quantities

Example 7

Oil Valuation
(pre June 2000 for Federal)

- Third Benchmark: Arithmetic average of other contemporaneous AL contract prices for significant quantities of like-quality oil in the same area or nearby area.
  - Include premiums paid above posted prices

Oil Valuation
(pre June 2000 for Federal)

- Fourth Benchmark: Prices received for AL spot sales of significant quantities of like-quality oil from the same field or area and other relevant matters.
  - Use when no AL posted prices or sales contracts exist in the same field, area or nearby areas.

Oil Valuation
(pre June 2000 for Federal)

- Fifth Benchmark: A net-back method or any other reasonable method to determine value
  - Apply on a case-by-case basis
  - A net-back method is intended for use primarily where the form of the lease product has changed, and it is necessary to start with the sales price of the changed product and deduct transportation and processing costs.

    (from the preamble to the 1988 oil valuation regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1196.)

Oil Valuation
(pre June 2000 for Federal)

- 30 CFR § 206.52 (h) and 206.102 (h):
  - Under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.

Audit/Compliance Approach

- Determine the first applicable benchmark value and compare to gross proceeds. Value for royalty purposes is the higher of the two.
- See slides 45 – 47 for more discussion of gross proceeds, duty to market, and marketable condition.

Federal Coal

Federal Coal

- Valuation regulations apply only to ad valorem leases
- 30 CFR 206.257 (c) (1) Valuation standards for NAL coal sales from ad valorem leases
- The value of coal will be based upon the first applicable of 5 criteria (benchmarks).

Federal Coal

- Determine the first applicable benchmark value and compare to gross proceeds. Value for royalty purposes is the higher of the two.

Federal Coal

First benchmark:

- Gross proceeds under the lessee's NAL contract, if within the range of gross proceeds from comparable AL contracts between buyers and sellers neither of whom is affiliated with the lessee, for like quality coal produced in the area.
  - Include sales, purchases, or other dispositions
  - Determine comparability based on factors:
    - Price, time of execution, duration, markets served, terms, quality, and other factors

Federal Coal

First benchmark:

Example 8

Federal Coal

Second benchmark:

- Prices reported for that coal to a public utility commission.

Federal Coal

Second benchmark:

Example 9

Federal Coal

Third benchmark:

- Prices reported for that coal to the Energy Information Administration of the Department of Energy.

Federal Coal

Third benchmark:

Example 10

Federal Coal

Fourth benchmark:

- Other relevant matters published or publicly available spot market prices.
- Or information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of coal.

Federal Coal

Fourth benchmark:

Example 11

Federal Coal

Fifth benchmark:

A net-back or any other reasonable method.

- "The MMS will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable. In doing a net-back, MMS will start at the first point at which a market value for the product can be determined, and will deduct costs of transportation, washing, handling, etc. to reach a value for royalty purposes."

  (from the preamble to the 1989 coal valuation regulations, *Federal Register*, Vol. 54, No. 9, January 13, 1989, page 1506.)

Federal Coal

Fifth benchmark:

Example 12

Federal Coal

- 30 CFR 206.257 (g) Valuation standards for ad valorem leases
  - For royalty purposes the value may not be less than the gross proceeds accruing to the lessee for coal production. Less applicable provisions of 206.257 (b)(5) and less applicable allowances.

Federal Coal

- 30 CFR 206.257 (b) (5)
- The value of production for royalty purposes shall not include payments received by the lessee pursuant to a contract which the lessee demonstrates, to MMS's satisfaction, were not part of the total consideration paid for the purchase of coal production.

Federal Coal – Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
  - Total monies and other consideration accruing to the lessee for the production and disposition of the coal produced.

Federal Coal – Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
  - Includes, but is not limited to: payments to the lessee for certain services such as crushing, sizing, screening, storing, mixing, loading, treatment and other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

Federal Coal – Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
  - Also includes, but is not limited to
    - Reimbursements for royalties, taxes, or fees
    - And other reimbursements
  - Tax reimbursements are part of the gross proceeds even though the Federal royalty interest may be exempt from taxation

Federal Coal – Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
  - Monies and other consideration to which a lessee is entitled, but which it does not seek to collect through reasonable efforts are also part of gross proceeds

Federal Coal – Gross Proceeds

- Gross Proceeds may include:
  - Sales proceeds (including contract entitlements not collected)
  - Price adjustments
  - Payments made on behalf of the purchaser
  - Non-cash consideration – including:
    - mining equipment/facilities
    - marketable condition services and marketing services
    - discounted electricity rates
    - water rights
    - any other thing of value (my personal favorite)
  - Added-value of marketable condition
  - Pre- and Post-production payments
  - Settlement payments

Federal Coal – Gross Proceeds

- Gross proceeds does NOT include:
  - Ash haulage to pit
  - Limestone haulage to power plant
  - Chemical alteration
  - Beneficiation
  - Force Majeure
  - Liquidated damages (contract breach)
  - Buyout