Minerals Management Service (MMS)
Minerals Revenue Management (MRM)

# Sales to Affiliates: Gas, Oil & Coal

2004

# Sales to Affiliates: Gas, Oil & Coal

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## Outline of Training

- Purpose of training
- Fina Decision
- Federal Gas – NAL Valuation
- Indian Gas - NAL Valuation prior to January 1, 2000
- Federal Oil – NAL Valuation prior to June 1, 2000 and Indian
- Indian Oil
- Federal Coal – NAL Valuation

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# Purpose of Training

To provide you with information and guidance on how to value sales of oil, gas, and coal, which is not sold at arm's-length, produced from Federal and Indian lands. You will apply the concepts learned by working exercises.

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# Applicability

- When conducting an audit or compliance review, the auditor or analyst must determine which valuation regulations apply:
  - Indian or Federal oil?
  - If Federal oil, before or after June 1, 2000?
  - Indian or Federal gas?
  - If Indian gas, before or after January 1, 2000?
  - Processed or unprocessed gas?
  - Federal or Indian coal?
  - Are sales or dispositions at arm's-length or other than arm's-length?

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## Applicability

The concepts presented in this course are relevant for:

- Federal gas,
- Indian gas prior to January 1, 2000,
- Indian gas after January 1, 2000 and not in an index zone,
- Federal oil prior to June 1, 2000, and
- Federal coal

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## Acronyms

- AL = arm's-length (sales type code ARMS)
- NAL = not sold under an arm's-length contract (sales type code NARM)

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## Fina Decision

- *Fina Oil and Chemical Corp. v. Norton, 332 F 3d 672 (D. C. Cir. 2003)*
- Rejects the Secretary of the Interior's decision in Texaco Exploration and Production Inc., MMS-92-0306-O&G, May 18, 1999

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## Fina Decision

- Value gas sold to affiliates that are not marketing affiliates [as defined in 30 CFR 206.101 (oil) and 206.151 (gas)] based on the first applicable benchmark.
- The court overturned a portion of the Texaco decision which held that gross proceeds were based on a wholly-owned or wholly-commonly-owned affiliate's first arm's-length resale.

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# Fina Decision

- Under the current Federal gas rule [30 CFR 206.152 (h) and 153 (h)], Indian oil rule [30 CFR 206.52 (h)], and Indian gas rule for leases outside an index zone [30 CFR 206.174 (g)], the value for royalty purposes is no less than the lessee's gross proceeds under its NAL contracts, less applicable allowances, not the wholly-owned or wholly-commonly-owned affiliate's AL resale price.

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# Fina Decision

"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, 53 Fed. Reg. at 1243, January 15, 1988, as quoted in the Fina decision.)

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## Fina Decision

"Gas sold directly to unaffiliated entities is valued at the contract price, since that price reliably indicates objective value."

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## Fina Decision

"In contrast, gas sold to marketing affiliates is valued not on the basis of the initial sale – obviously an unreliable indicator of objective value – but rather on the basis of the price at which it ultimately leaves the corporate family."

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## Fina Decision

"...gas sold to non-marketing affiliates – where the objective value can be reliably approximated through comparable arm's-length sales – is valued through the benchmarks at the initial sales price and not the subsequent resale price."

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## Concepts - Affiliation

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

30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.151, Federal Gas; 30 CFR 206.171, Indian Gas.

This definition does not apply to coal.

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# Concepts - Affiliation

Affiliate – means a person who controls, is controlled by, or is under common control with another person.

Affiliate is defined in 30 CFR 206.101 for Federal Oil, effective June 1, 2000, but is not defined in the regulations for other products.

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# Concepts - Affiliation

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.

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## Concepts - Affiliation

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

- Ownership > 50% assume control
- Ownership between 10% and 50%: consider various factors
- Ownership < 10% assume non-control: MMS may rebut

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## Concepts - Affiliation

- The National Mining Association decision identified 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)*

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# Concepts - Affiliation

- 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

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# Concepts - Affiliation

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

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# Concepts - Affiliation

- See the August 21, 2000, guidance paper, "Guidance for Determining Control for Ownership Between 10-50 Percent in Light of the National Mining Association (NMA) Decision", signed by the Associate Director for Royalty Management.

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# FEDERAL GAS
# NAL VALUATION

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## Federal Gas Definitions

Lessee:

...any person to whom the United States issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000).

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## Federal Gas Definitions

Lessee (cont'd):

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 that royalty payment responsibility.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Gas Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the gas, residue gas, and gas plant products produced.

30 CFR 206.151, Federal Gas

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## Federal Gas Definitions

Gross Proceeds (cont'd).

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
  - dehydration,
  - measurement, and/or
  - gathering
  - to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

30 CFR 206.151, Federal Gas

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## Federal Gas Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

30 CFR 206.151, Federal Gas

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## Federal Gas Definitions

Gross Proceeds (cont'd).

Monies and other consideration,

- including the forms of consideration identified in this paragraph,
- to which a lessee is contractually or legally entitled
- but which it does not seek to collect through reasonable efforts

are also part of gross proceeds.

30 CFR 206.151, Federal Gas

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## Federal Gas Definitions

- *Marketable condition* means lease products that 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.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

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## Federal Gas Definitions

Marketable Condition – (Cont'd)

- lessee must meet pressure and quality requirements (Btu, moisture content, H2S, CO2) for the pipeline that transports the gas to market.

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## Federal Gas Definitions

*Like-quality lease products* means lease products which have similar chemical, physical, and legal characteristics.

30 CFR 206. 151

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## Federal Gas - NAL Valuation Rules

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.

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## Federal Gas – NAL Valuation Unprocessed Gas - Rules

- First benchmark
- The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by 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). 30 CFR 206.152 (c) (1) (underlining added)

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## Federal Gas – NAL Valuation Unprocessed Gas - Rules

- First benchmark
- "...comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field...or area." Not limited to sales at the lease.
- Purchases or sales of like-quality gas produced from the same field or area, regardless of where sold, may be comparable transactions.

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# Federal Gas – NAL Valuation Unprocessed Gas - Rules

- First benchmark (cont'd.)
- 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 the gas
  - Volume
  - And such other factors as may be appropriate to reflect the value of the gas

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# Federal Gas – NAL Valuation Unprocessed Gas - Rules

- Second Benchmark
- A value determined by consideration of other information relevant in valuing like-quality gas, including
  - gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas
  - posted prices for gas
  - prices received in arm's-length spot sales of gas
  - other reliable public sources of price or market information
  - and other information as to the particular lease operation or the saleability of the gas
  - 30 CFR 206.152 (c) (2)

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## Federal Gas – NAL Valuation Unprocessed Gas - Rules

- Third Benchmark
- A net-back or any other reasonable method to determine value.
- 30 CFR 206.152 (c) (1)

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## Federal Gas – NAL Valuation Processed Gas - Rules

- First benchmark
- The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by 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 residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). 30 CFR 206.153 (c) (1)

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## Federal Gas – NAL Valuation Processed Gas - Rules

- First benchmark (cont'd.)
- 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 residue gas or gas plant products
  - *Volume*
  - And such other factors as may be appropriate to reflect the value of the residue gas or gas plant products

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## Federal Gas – NAL Valuation Processed Gas - Rules

- Second Benchmark
- A value determined by consideration of other information relevant in valuing like-quality residue gas or gas plant products, including
  - gross proceeds under arm's-length contracts for like-quality residue gas or gas plant products from the same gas plant or other nearby processing plants
  - posted prices for residue gas or gas plant products
  - prices received in spot sales of residue gas or gas plant products
  - other reliable public sources of price or market information
  - and other information as to the particular lease operation or the saleability of such residue gas or gas plant products
  - 30 CFR 206.153 (c) (2)

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# Federal Gas – NAL Valuation Processed Gas - Rules

- Third Benchmark
- A net-back or any other reasonable method to determine value.
- 30 CFR 206.153 (c) (1)

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# Federal Gas – NAL Valuation
## Benchmark One

- First Benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable AL contracts in the field or area.
  - Two criteria: equivalency and comparability.
  - If the NAL gross proceeds are greater than or equal to AL gross proceeds under comparable contracts, then accept the NAL gross proceeds.

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# Federal Gas – NAL Valuation
## Benchmark One

- Equivalency:
  - If there are many comparable contracts, and the lessee's NAL gross proceeds are within the range of prices under those contracts, then those NAL gross proceeds are acceptable for value.
  - As long as there is at least one comparable AL contract that sets a price that is less than the lessee's NAL price, the lessee's NAL gross proceeds will be acceptable.

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# Federal Gas – NAL Valuation
## Benchmark One

- Comparability:
  - **Price**: *components* of the contract price (transportation factors, marketing costs, etc.)
  - **Time of execution**
  - **Duration**: contract period, long-term or short-term
  - **Market or markets served**
  - **Terms**
  - **Quality**: methane content, NGL content, Btu content, non-hydrocarbon gas content (hydrogen sulfide, $CO_2$, etc.)
  - **Volume**: delivered quantity
  - **Other factors**: any other factors which affect value

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## Federal Gas – NAL Valuation
### Benchmark One

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.

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## Federal Gas – NAL Valuation
### Benchmark One

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, Federal Gas

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# Federal Gas – NAL Valuation

## Benchmark One

Example of Comparability Factors

The lessee being audited produces 200,000 Mcf and sells the production under a NAL contract for $3.79 per Mcf.

We have been able to identify the following AL contracts for purchases or sales in the same field or area:

| Purchaser/Seller | Volume in Mcf | Price |
|---|---|---|
| A & R Corp | 150,000 | 3.65 |
| BW Gas Inc | 413,000 | 5.41 |
| Cad Energy | 200,000 | 5.29 |
| Tee Corp | 359,000 | 5.68 |
| JW Petroleum | 10,000 | 5.27 |

Is our price acceptable under the first benchmark?

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# Federal Gas – NAL Valuation

## Benchmark One

Example of Comparability Factors

The lessee being audited produced 200,000 Mcf in July 2001 and sold the production under a NAL contract for $4.29 per Mcf. The contract was for a 4-year term, effective 1/1/2000 through 12/31/2004.

We have been able to identify the following AL contracts for purchases or sales in the same field or area:

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

Is our lessee's price acceptable under the first benchmark?

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# Federal Gas – NAL Valuation
## Benchmark One

Example of Comparability Factors:

The lessee being audited produced 150,000 Mcf of gas and sold it under a NAL contract for $3.99 per MMBtu. The quality of the gas was: Btu – 1041; Gas composition - 0.89% inert gas; NGL % - 2.98.

We have been able to identify the following AL contracts for purchases or sales of gas in the field or area:

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

Is our lessee's NAL price acceptable under the first benchmark?

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# Federal Gas – NAL Valuation
## Benchmark One

Examples 1 - 4

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# Federal Gas – NAL Valuation
## Benchmark Two

- 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.

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# Federal Gas – NAL Valuation
## Benchmark Two

- Second benchmark (cont'd.)
- Used when benchmark one fails for any reason, including:
  - 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

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# Federal Gas – NAL Valuation

## Benchmark Two

- Second Benchmark (cont'd):

  Lessee must consider other relevant information in valuing like-quality gas produced from the field or area, or processed at the same plant or nearby plants

  - Gross proceeds under AL contracts
  - Published or posted prices
  - AL spot prices (note that the processed gas regulations do not require that spot prices be at AL)
  - Other reliable public sources
  - Any information unique to the property

**These considerations do not need to be applied in any particular order.**

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# Federal Gas – NAL Valuation

## Benchmark Two

Examples 5 and 6

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# Federal Gas – NAL Valuation

## Benchmark Three

- Third Benchmark: A net-back method or any other reasonable valuation method.
  - Applied in any case where benchmarks one and two fail (cannot be applied)
  - 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.)

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# Federal Gas – NAL Valuation

## Audit/Compliance Approach

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## Federal Gas – NAL Valuation
### Audit/Compliance Approach

- Determine the first applicable benchmark value.
- If benchmark one applies, then the lessee's NAL gross proceeds are accepted for determining royalty value.

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## Federal Gas – NAL Valuation
### Audit/Compliance Approach

- The benchmarks must be applied in order.
- You cannot move on to benchmark two (or three) unless benchmark one (or two) fails for some reason.
- The fact that benchmark two (or three) might be easier to apply to your situation is not a reason to skip over benchmark one (or two).

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- To determine gross proceeds:
  - Add back any costs deducted for putting the production into marketable condition
  - Add any reimbursement received for costs incurred in putting the production into marketable condition
  - Increase value by any costs incurred by any other party to put the production into marketable condition

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- To determine gross proceeds:
  - Add back any marketing costs expressly deducted from the lessee's gross proceeds
  - Add any reimbursement expressly identified as for marketing the product.
  - Increase value by costs incurred by any other party to market the production
  - The gain derived from an affiliate's marketing efforts is not part of the lessee's gross proceeds.

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# Federal Gas – NAL Valuation Audit/Compliance Approach

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

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# Federal Gas – NAL Valuation
## 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)

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- Access to records
  - We have authority to get records from anyone, per FOGRMA, which says:
  - Sec. 103. (a) A lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this Act through the point of first sale or the point of royalty computation, whichever is later, shall establish and maintain any records, make any reports, and provide any information that the Secretary may, by rule, reasonably require for the purposes of implementing this Act or determining compliance with rules or orders under this Act.

30 USC 1713, Federal Oil and Gas Royalty Management Act of 1982

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- Access to records (con't.)
  - Upon the request of any officer or employee duly designated by the Secretary or any State or Indian tribe conducting an audit or investigation pursuant to this Act, the appropriate records, reports, or information which may be required by this section shall be made available for inspection and duplication by such officer or employee, State, or Indian tribe.

30 USC 1713, Federal Oil and Gas Royalty Management Act of 1982

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- Access to records
  - See 132 IBLA 354, May 11, 1995, Shell Oil Co. (which reversed 130 IBLA 93, August 1, 1994, Shell Oil Co.)
  - This case dealt with access to records of an affiliate in order to determine gross proceeds applicable to the lessee.

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# Federal Gas – NAL Valuation
## Audit/Compliance Approach

- Access to records
- 132 IBLA 354 (Cont'd.)
- "MMS had statutory and regulatory authority to require production of documents concerning crude oil sales contracts made by an affiliate of a Federal oil and gas lessee that were needed to insure there had been compliance with the gross proceeds rule established by Departmental regulation 30 CFR 206.102 (h) (1989)."

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# INDIAN GAS
# NAL VALUATION

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## Indian Gas
## Definitions

Lessee:

...any person to whom an Indian Tribe, or an Indian allottee issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

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## Indian Gas 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.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

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## Indian Gas Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of unprocessed gas, residue gas, and gas plant products produced.

30 CFR 206.171, Indian Gas

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## Indian Gas Definitions

Gross Proceeds (cont'd):

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
  - compression,
  - dehydration,
  - measurement, and/or
  - field gathering
  - to the extent that the lessee is obligated to perform them at no cost to the Indian lessor, and payments for gas processing rights.

30 CFR 206.171, Indian Gas

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## Indian Gas Definitions

- Gross Proceeds (cont'd).
  - Gross proceeds, as applied to gas, also includes, but is not limited to reimbursements for severance taxes and other reimbursements.

30 CFR 206.171, Indian Gas

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## Indian Gas Definitions

- Gross Proceeds (cont'd).
  - Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Indian royalty interest may be exempt from taxation.

30 CFR 206.171, Indian Gas

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## Indian Gas Definitions

Gross Proceeds (cont'd).

Monies and other consideration,

- including the forms of consideration identified in this paragraph,
- to which a lessee is contractually or legally entitled
- but which it does not seek to collect through reasonable efforts

are also part of gross proceeds.

30 CFR 206.171, Indian Gas

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## Indian Gas Definitions

- *Marketable condition* means lease products that 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.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

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## Indian Gas – NAL Valuation Rules

- Former regulations: 30 CFR 206.172-173 (1999)
  - The same benchmarks discussed under Federal gas valuation apply
- Current regulations: 30 CFR 206.172-173 (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

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# FEDERAL OIL
# NAL VALUATION

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## Federal Oil
## Definitions

<u>Lessee:</u>

...any person to whom the United States issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

Lessee (cont'd):

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 that royalty payment responsibility.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

Lessee:

...any person to whom the United States issues an oil and gas lease, an assignee of all or a part of the record title interest, or any person to whom operating rights in a lease have been assigned.

30 CFR 206. 101, Federal Oil (after June 1, 2000)

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## Federal Oil Definitions

Gross Proceeds (for royalty payment purposes) means the total moneys and other consideration accruing to an oil and gas lessee for the disposition of the oil produced.

30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds, as applied to oil, also includes, but is not limited to, reimbursements for harboring or terminaling fees.

30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

<u>Gross Proceeds</u> (cont'd).

Moneys and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

30 CFR 206.101, Federal Oil (pre-June 2000)

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## Federal Oil Definitions

- *Marketable condition* means lease products that 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.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

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# Federal Oil Definitions

- Marketable Condition (con't.)
- "The lessee is required to place oil in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement or this section."
- 30 CFR 206.102(i), Federal Oil

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# Federal Oil Definitions

- Marketable Condition (cont'd.)
- "Where the value established under this section is determined by a lessee's gross proceeds, that value shall 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 oil in marketable condition."
- 30 CFR 206.102(i), Federal Oil

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## Federal Oil Definitions

*Like-quality lease products* means lease products which have similar chemical, physical, and legal characteristics.

30 CFR 206. 101

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## Federal Oil Definitions

*Posted price* means the price specified in publicly available posted price bulletins, offshore or onshore terminal postings, or other price notices net of all adjustments for quality (e.g., API gravity, sulfur content, etc.) and location for oil in marketable condition.

30 CFR 206.101

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# Federal Oil Definitions

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

- the seller unconditionally transfers title to the oil to the buyer and does not retain any related rights such as the right to buy back similar quantities of oil from the buyer elsewhere
- the buyer pays money or other consideration for the oil
- the parties' intent is for a sale to occur

30 CFR 206.101 (2003), Federal Oil,

91

# Federal Oil – NAL Valuation (pre-June 2000)

- Regulatory Authority
  - 30 CFR 206.102
  - Valuation standards for Federal oil (prior to June 1, 2000)
    - (c) The value of oil production from leases subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following paragraphs [the benchmarks]:
    - (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...

92

# Federal Oil – NAL Valuation Rules (pre-June 2000)

- First Benchmark:
  - The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);
  - 30 CFR 206.102 (c) (1) (pre-June 2000)

93

# Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
  - provided, however, that those posted prices or oil sales contract prices are comparable to *other contemporaneous posted prices or oil* sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area.)
  - 30 CFR 206.102 (c) (1) (pre-June 2000)

94

## Federal Oil – NAL Valuation (pre-June 2000)

- For purposes of this paragraph [all of 206.102], the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred.

30 CFR 206.102 (c) (6) (pre-June 2000)

95

## Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
  - In evaluating the comparability of posted prices or oil sales contract prices, the following factors should be considered:
    - Price
    - Duration
    - Market or markets served
    - Terms
    - Quality of oil
    - Volume, and
    - Other factors as may be appropriate to reflect the value of the oil. 30 CFR 206.102 (c) (1) (pre-June 2000)

96

# Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
  - If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume weighted average price for the purchases or sales for the production month will be used.

30 CFR 206.102 (c) (1) (pre-June 2000)

97

# Federal Oil – NAL Valuation (pre-June 2000)

- 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.)

98

# Federal Oil – NAL Valuation
## 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 |
|---|---|
| Purchaser A | 400,000 (80%) |
| Purchaser B | 35,000 (7%) |
| Purchaser C | 35,000 (7%) |
| Purchaser D | 20,000 (4%) |
| Purchaser E | 10,000 (2%) |

Purchaser A buys significant quantities of production from Happy Canyon Field. Do B & C? What if B, C, D, and E (total of 20%) all purchase from the same producer? Is that production significant? What if only the quantity purchased by B is of like-quality to that of the lessee?

99

# Federal Oil – NAL Valuation
## Significant Quantities
## Example

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

| Buyer | Quantity |
|---|---|
| Purchaser A | 1,000 (1%) |
| Purchaser B | 5,000 (5%) |
| Purchaser C | 15,000 (15%) |
| Purchaser D | 18,000 (18%) |
| Purchaser E | 22,000 (22%) |
| Purchaser F | 25,000 (25%) |
| Purchaser G | 14,000 (14%) |

Purchasers C, D, E, F & G all buy significant quantities of production from this field. Is B significant? What if B has the only AL sales or purchases in the field?

***Note: What is significant in one field or area might be insignificant in another.***

100

# Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
  - The first benchmark for oil is not a question of the acceptability of the lessee's NAL gross proceeds, as it is for gas.
  - It is, instead a comparison of the lessee's AL "contemporaneous posted prices or oil sales contract prices" to comparable AL prices.

101

# Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 1 and 2

102

# Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
  - If the first benchmark fails because:
    - The lessee has no comparable AL transactions
    - AL transactions are not of significant quantities
    - Or there are no AL sales or purchases of like-quality production in the field or area to compare the lessee's prices to,
  - Go to benchmark two

103

# Federal Oil – NAL Valuation (pre-June 2000)

- Second Benchmark:
  - The arithmetic average of contemporaneous posted prices
    - Used in arm's-length transactions
    - By persons other than the lessee
    - For purchases or sales of significant quantities
    - Of like-quality oil
    - In the same field (or, if necessary to obtain a reasonable sample, from the same area)

30 CFR 206.102 (c) (2) (pre-June 2000)

104

# Federal Oil – NAL Valuation (pre-June 2000

Oil Example 3 and 4

105

# Federal Oil – NAL Valuation (pre-June 2000)

- Second Benchmark:
  - If there are no
    - Contemporaneous posted prices
    - Used in arm's-length transactions
    - By persons other than the lessee for purchases or sales
    - Of significant quantities
    - Of like-quality oil
    - In the same field (or, if necessary to obtain a reasonable sample, from the same area)
  - Move on to benchmark three

106

# Federal Oil – NAL Valuation (pre-June 2000)

- Third Benchmark:
  - The arithmetic average of other contemporaneous arm's-length contract prices for purchase or sales of significant quantities of like-quality oil in the same area or nearby areas.
  - 30 CFR 206.102 (c) (3) (pre-June 2000)

107

# Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 5

108

## Federal Oil – NAL Valuation (pre-June 2000)

- Third Benchmark:
  - If there are no
    - Contemporaneous AL contract prices for purchases or sales
    - Of significant quantities
    - Of like-quality oil
    - In the same area or nearby areas,
  - Move on to benchmark four

109

## Federal Oil – NAL Valuation (pre-June 2000)

- Fourth Benchmark:
    - Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area),
    - And other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil
  - 30 CFR 102 (c) (4) (pre-June 2000)

110

# Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 6

111

# Federal Oil – NAL Valuation (pre-June 2000)

- Fourth Benchmark:
  - If there are no
    - **AL spot sales**
    - **of significant quantities**
    - **of like-quality oil**
    - **from the same field (or, if necessary to obtain a reasonable sample, from the same area),**
    - **And you cannot determine other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil by which to value this oil,**
  - Move on to benchmark five

112

## Federal Oil – NAL Valuation (pre-June 2000)

- Fifth Benchmark:
  - A net-back method or any other reasonable method to determine value.
    30 CFR 206.102 (c) (5)
  - 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.)

113

## Federal Oil – NAL Valuation (pre-June 2000)

- 30 CFR § 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.

114

## Federal Oil – NAL Valuation
### 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 the "NAL Gas Valuation – Federal, Audit/Compliance Approach" section of this presentation for more discussion of gross proceeds, duty to market, and marketable condition.

115

## INDIAN OIL
## NAL VALUATION

116

## Indian Oil Definitions

Lessee:

...any person to whom an Indian Tribe, or an Indian allottee issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

117

## Indian Oil 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.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

118

## Indian Oil Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the oil produced.

30 CFR 206.51, Indian Oil

119

## Indian Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Indian lessor.

30 CFR 206.51, Indian Oil

120

# Indian Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds , as applied to oil, also includes, but is not limited to, reimbursements for harboring and terminaling fees.

30 CFR 206.51, Indian Oil

121

# Indian Oil Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Indian royalty interest may be exempt from taxation.

30 CFR 206.51, Indian Oil

122

## Indian Oil Definitions

Gross Proceeds (cont'd).

Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

30 CFR 206.51, Indian Oil

123

## Indian Oil Definitions

- *Marketable condition* means lease products that 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.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

124

## Indian Oil Definitions

- Marketable Condition (con't.)
- "The lessee is required to place oil in marketable condition at no cost to the Indian lessor unless otherwise provided in the lease agreement or this section."
- 30 CFR 206.52(i), Indian Oil

125

## Indian Oil Definitions

- Marketable Condition (cont'd.)
- "Where the value established under this section is determined by a lessee's gross proceeds, that value shall 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 oil in marketable condition."
- 30 CFR 206.52(i), Indian Oil

126

# Indian Oil – NAL Valuation Rules

- Regulatory Authority
  - 30 CFR 206.52 (c) and (h) Valuation standards for Indian oil
    - The value shall be the reasonable value determined under the first applicable benchmark, but no less than gross proceeds.
  - 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 NAL gross proceeds. The higher of these two values will be compared to the major portion value and the value for royalty purposes shall be the higher of these two.

127

# Indian Oil – NAL Valuation

- First Benchmark:
  - The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);
  - 30 CFR 206.52 (c) (1)

128

# Indian Oil – NAL Valuation

- First Benchmark:
  - provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area.)
  - 30 CFR 206.52 (c) (1)

129

# Indian Oil – NAL Valuation

- For purposes of this paragraph [all of 206.52], the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred.

30 CFR 206.52 (c) (6)

130

# Indian Oil – NAL Valuation

- First Benchmark:
  - In evaluating the comparability of posted prices or oil sales contract prices, the following factors should be considered:
    - Price
    - Duration
    - Market or markets served
    - Terms
    - Quality of oil
    - Volume, and
    - Other factors as may be appropriate to reflect the value of the oil. 30 CFR 206.52 (c) (1)

131

# Indian Oil – NAL Valuation

- Second Benchmark:
  - The arithmetic average of contemporaneous posted prices
    - Used in arm's-length transactions
    - By persons other than the lessee
    - For purchases or sales of significant quantities
    - Of like-quality oil
    - In the same field (or, if necessary to obtain a reasonable sample, from the same area)

30 CFR 206.52 (c) (2)

132

# Indian Oil – NAL Valuation

- Third Benchmark:
  - The arithmetic average of other contemporaneous arm's-length contract prices for purchase or sales of significant quantities of like-quality oil in the same area or nearby areas.
  - 30 CFR 206.52 (c) (3)

133

# Indian Oil – NAL Valuation

- Fourth Benchmark:
  - Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area),
  - And other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil
  - 30 CFR 52 (c) (4)

134

## Indian – NAL Valuation

- Fifth Benchmark:
  - A net-back method or any other reasonable method to determine value.
    30 CFR 206.52 (c) (5)
  - 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.)

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## FEDERAL COAL NAL VALUATION

136

## Federal Coal

- Valuation regulations apply only to ad valorem leases (All cents-per-ton leases have been converted.)
- 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).

137

## Federal Coal

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

138

# Federal Coal

First benchmark:

- The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition of produced coal by other than an arm's-length contract), provided that those gross proceeds are:

139

# Federal Coal

First benchmark (cont'd):

- within the range of the gross proceeds
- derived from, or paid under, comparable arm's-length contracts
- between buyers and sellers neither of whom is affiliated with the lessee
- for sales, purchases, or other dispositions of like-quality coal produced in the area.

140

## Federal Coal

First benchmark (cont'd):

- 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 coal
  - Quantity
  - And such other factors as may be appropriate to reflect the value of the coal 30 CFR 206.257 (c) (2) (i)

141

## Federal Coal

First benchmark:

Coal Example 1

142

# Federal Coal

Second benchmark:

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

30 CFR 206.257 (c) (2) (ii)

143

# Federal Coal

Second benchmark:

Coal Example 2

144

# Federal Coal

Third benchmark:

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

30 CFR 206.257 (c) (2) (iii)

http://www.eia.doe.gov/cneaf/electricity/page/ferc423.html

145

# Federal Coal

Third benchmark:

Coal Example 3

146

# Federal Coal

Fourth benchmark:

Other relevant matters, including but not limited to:

- 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.

30 CFR 206.257 (c) (2) (iv)

147

# Federal Coal

Fourth benchmark:

Coal Examples 4 - 5

148

# Federal Coal

Fifth benchmark:

- A net-back method or any other reasonable method.

  30 CFR 206.257 (c) (2) (v)

- "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.)

149

# Federal Coal

Fifth benchmark:

Coal Example 6

150

## 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.

151

## 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.

152

# 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.

153

# Federal Coal
## Gross Proceeds

30 CFR 206.251:

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
  - crushing,
  - sizing,
  - screening,
  - storing,
  - mixing,
  - loading,
  - treatment with substances including chemicals or oils,
  - and other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

154

# 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 accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

155

# Federal Coal
## Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
  - Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

156

# 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

157

# 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

158

# United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued May 12, 2003 Decided June 27, 2003

No. 02-5241

FINA OIL AND CHEMICAL COMPANY AND
PETROFINA DELAWARE, INC.,
APPELLANTS

v.

GALE A. NORTON, SECRETARY OF THE INTERIOR,
APPELLEE

Appeal from the United States District Court
for the District of Columbia
(No. 99cv02392)

*Charles D. Tetrault* argued the cause for appellants. With him on the briefs was *Daniel A. Petalas*.

*L. Poe Leggette* and *Nancy L. Pell* were on the brief for *amicus curiae* Independent Petroleum Association of America in support of appellants.

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

*John P. Wagner*, *Joshua B. Frank*, and *Thomas J. Eastment* were on the brief for *amicus curiae* American Petroleum Institute in support of appellants. *David T. Deal* entered an appearance.

*Todd S. Aagaard*, Attorney, U.S. Department of Justice, argued the cause for appellee. With him on the brief were *Edward S. Geldermann* and *Ronald M. Spritzer*, Attorneys.

Before: GINSBURG, *Chief Judge*, and ROGERS and TATEL, *Circuit Judges*.

Opinion for the Court filed by *Circuit Judge* TATEL.

TATEL, *Circuit Judge*: Under federal law, firms that extract natural gas from leased federal, tribal, or offshore lands pay the government royalties calculated as a percentage of the value of the production they extract. This case involves a valuation dispute concerning gas that is sold twice: first by the producer to a gas marketing firm it controls, and then by the controlled marketing firm to end-users. The Secretary of the Interior valued the gas production based on the contract price of the resale. Challenging that decision, the producer argues that the Secretary should have valued the production based on the lower contract price of the initial sale. Because the applicable regulation unambiguously requires valuation based on the initial sale, we reject the Secretary's contrary interpretation. Though we express no opinion on whether the Secretary might have statutory authority to value production based on the resale price, the Secretary may not do so by interpreting a regulation to mean the opposite of its plain language.

## I.

Through its Minerals Management Service (MMS), the Department of the Interior issues and administers gas leases for federal lands, Indian tribal and allotted lands, and the Outer Continental Shelf. *See* Mineral Leasing Act, 30 U.S.C. § 181 *et seq.* (federal lands); Mineral Leasing Act for Acquired Lands, 30 U.S.C. § 351 *et seq.* (acquired federal lands); 25 U.S.C. §§ 396, 396a–396g (Indian tribal and allotted lands); Outer Continental Shelf Lands Act, 43 U.S.C. § 1331 *et seq.* (Outer Continental Shelf). *See generally Indep. Petroleum Ass'n v. Babbitt*, 92 F.3d 1248, 1251–52 (D.C. Cir. 1996). Under such leases, private companies sell gas production directly and then compensate the government with royalties calculated as a percentage of the "value of the production" removed or sold from the leased lands. 30 U.S.C. § 226(b) (federal lands); 43 U.S.C. § 1337(a)(1) (Outer Continental Shelf); 25 C.F.R. §§ 211.41(b) & 212.41(b) (Indian tribal and allotted lands). Concerned that "the system of accounting with respect to royalties and other payments due and owing on . . . gas produced from [federal, tribal, and offshore] lease sites is archaic and inadequate," 30 U.S.C. § 1701(a)(2), Congress enacted the Federal Oil and Gas Royalty Management Act (FOGRMA), 30 U.S.C. § 1701 *et seq.* (1982), which directed the Secretary to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system to provide the capability to accurately determine . . . gas royalties . . . owed, and to collect and account for such amounts in a timely manner," 30 U.S.C. § 1711(a).

Pursuant to FOGRMA and the leasing statutes, the MMS promulgated a regulation establishing methods for determining the "value of the production" for royalty calculation purposes. *See* Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (Jan. 15, 1988) (codified at 30 C.F.R. §§ 206.152 (unprocessed gas), 206.153 (processed gas)). The regulation establishes three different valuation methodologies, depending on the particular entity to whom producers first sell the gas. Gas sold directly to non-affiliated purchasers under ordinary "arm's-length contract[s]" is valued on the basis of "gross proceeds accruing to the lessee"—a defined term meaning total direct and indirect consideration under the contract. 30 C.F.R. §§ 206.152(b)(1)(i) (unprocessed gas), 206.153(b)(1)(i) (processed gas), 206.151 (defining "arm's length contract" and "gross proceeds"). Gas sold to so-called marketing affiliates—entities that purchase gas exclusively from producers that own or control them—and subsequently resold by the marketing affiliates pursuant to arm's-length contracts is valued on the basis of downstream resales. 30 C.F.R. §§ 206.152(b)(1)(i) (unprocessed gas), 206.153(b)(1)(i) (processed gas), *206.151* (*defining* "marketing affiliate"). Gas sold to owned or controlled affiliated entities that, because they purchase at least some gas from sources other than their owning or controlling producer, are not "marketing affiliates" is valued on the basis of the first applicable of three benchmarks. 30 C.F.R. §§ 206.152(c) (unprocessed gas), 206.153(c) (processed gas). The first benchmark values gas based on "gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract, ... provided that those gross proceeds are equivalent to the gross proceeds *derived from* [comparable sales in the same field or area]." 30 C.F.R. §§ 206.152(c)(1) (unprocessed gas), 206.153(c)(1) (processed gas). The second benchmark values gas based on "information relevant in valuing like-quality gas," including "other reliable public sources of price or market information." 30 C.F.R. §§ 206.152(c)(2) (unprocessed gas), 206.153(c)(2) (processed gas). The third, which values gas based on another proxy for market price under an arm's-length contract, is irrelevant to this case. 30 C.F.R. §§ 206.152(c)(3) (unprocessed gas), 206.153(c)(3) (processed gas). *Finally*, and central to this case, the regulation contains a catch-all: "Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production." 30 C.F.R. §§ 206.152(h) (unprocessed gas), 206.153(h) (processed gas).

Appellants Fina Oil and Chemical Company and Petrofina Delaware, Inc. are natural gas producers holding onshore and offshore federal leases. (Like the parties, we shall call appellants "Fina.") Fina Natural Gas Company (FNGC) is a natural gas marketer that purchases gas from producers for resale to downstream end-users. Though controlled by Fina, FNGC is not a "marketing affiliate" because it purchases gas from both Fina and other gas producers. Fina therefore paid royalties based on its contract price with FNGC—a price which, according to Fina, complies with the first benchmark or, if the first benchmark is inapplicable, with the second.

In 1993, the MMS issued an order rejecting Fina's use of the benchmarks, requiring Fina instead to base its royalty valuation on the higher prices that FNGC receives from subsequent downstream arm's-length sales. Fina appealed to the Interior Board of Land Appeals, but while that appeal was pending, the Board decided *Seagull Energy Corp.*, 148 I.B.L.A. 300 (May 6, 1999), which reversed an MMS order substantially similar to the order in Fina's case and squarely rejected the MMS's position that gas sold to non-marketing affiliates and later resold to end-users must be valued based upon the resale price.

*Seagull* proved short-lived. Two weeks after it was issued, the Acting Assistant Secretary for Land and Minerals Management, with the Secretary of the Interior's concurrence, expressly overruled *Seagull* in a decision called *Texaco Exploration & Production, Inc.*, Docket No. MMS–92–0306–O&G (May 18, 1999). Though *Texaco* involved the valuation of oil, not gas, it presented the same legal issue we face here because the MMS's oil valuation and gas valuation regulations are identical for all relevant purposes, *see* Revision of Oil Product Valuation Regulations and Related Topics, 53 Fed. Reg. 1184 (Jan. 15, 1988) (codified at 30 C.F.R. §§ 202.101–.102), and because the oil was sold by a producer (like Fina) to a non-marketing affiliate (like FNGC). Holding the benchmarks inapplicable in valuing oil production resold at a profit by a non-marketing affiliate, *Texaco* expressly rejected *Seagull*'s reasoning on two grounds. First, *Texaco* noted that the gross proceeds provision requires all valuations to equal at a minimum the "gross proceeds accruing to the lessee," a term the decision interpreted as referring to the total consideration received by the corporate family to which the producer and non-marketing affiliate belong. Because the benchmarks measure only what the producer receives through intra-corporate transfers, not the total consideration the corporate family receives from resale, *Texaco* reasoned that the benchmarks yield valuations less than "gross proceeds accruing to the lessee" whenever a non-marketing affiliate resells gas for more than it originally paid its controlling producer. Thus, *Texaco* found that in such instances the gross proceeds provision supersedes the benchmarks, requiring the producer to calculate value based on its non-marketing affiliate's resale proceeds. Second, finding that oil and gas lessees have an implied duty to include in production valuations any increase in value resulting from marketing activities, *Texaco* concluded, alternatively, that a lessee may not base valuations on sales to a non-marketing affiliate that later turns around and performs marketing activities. *Texaco* at 12–22.

Because the Assistant Secretary issued *Texaco* under her discretionary authority to step into the MMS director's shoes and directly hear appeals from MMS orders, *Texaco* binds the Board. *See Texaco* at 27; *Blue Star, Inc.*, 41 I.B.L.A. 333 (1979) (finding Board bound by decision made by Assistant Secretary standing in the shoes of a subdepartment of the Department of the Interior); *Marathon Oil Co.*, 108 I.B.L.A. 177 (1989) (same). Accordingly, the Board summarily denied Fina's appeal, concluding that "[t]he arguments raised by appellants with respect to the value of production for royalty purposes have all been addressed in *Texaco*.... We therefore ... adopt the analysis and rational [sic] contained therein to affirm MMS." *Fina Oil & Chem. Co.*, 149 I.B.L.A. 168, 186 (June 11, 1999).

Fina filed suit in the United States District Court for the District of Columbia challenging the Board's decision under the Administrative Procedure Act, 5 U.S.C. § 551 *et seq.* On cross motions for summary judgment, the district court ruled for the Secretary. Reaching only *Texaco*'s second rationale, the district court found it "neither arbitrary nor capricious for the [Secretary] to conclude that Fina has some implied duty to market the gas it produces." *Fina Oil & Chem. Co. v. Norton*, 209 F. Supp. 2d 246, 253 (D.D.C. 2002). Fina now appeals.

## II.

Although Fina's challenge to the Secretary's interpretation of her own regulation comes to us on appeal from the district court, because we face a purely legal question, "our task [is] precisely the same as the district court's," *Occidental Petrole-*

*um Corp. v. SEC*, 873 F.2d 325, 340 (D.C. Cir. 1989), and "the [d]istrict [c]ourt's decision is not entitled to any particular deference," *Hennepin County v. Sullivan*, 883 F.2d 85, 91 (D.C. Cir. 1989). "[N]otwithstanding the intervening step," we thus "proceed as if the [Board's] decision had been appealed to this court directly." *Dr. Pepper/Seven–Up Cos. v. FTC*, 991 F.2d 859, 862 (D.C. Cir. 1993).

In reviewing the Board's application of its gas valuation regulations to Fina's operations and the Secretary's reasoning in *Texaco* that the Board adopted by reference, "[w]e must give substantial deference to an agency's interpretation of its own regulations." *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994). Courts, the Supreme Court has explained, lack authority to "decide which among several competing interpretations [of an agency's own regulation] best serves the regulatory purpose," *id.*, and instead must "give effect to the agency's interpretation so long as it . . . sensibly conforms to the purpose and wording of the regulations," *Martin v. Occupational Safety & Health Review Comm'n*, 499 U.S. 144, 150–151 (1991) (internal quotation marks and citations omitted). But to prevent agencies from circumventing the notice-and-comment process by rewriting regulations under the guise of interpreting them, we will reject an agency interpretation that is "plainly erroneous or inconsistent with the regulation." *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945); *cf. Darrell Andrews Trucking, Inc. v. Fed. Motor Carrier Safety Admin.*, 296 F.3d 1120, 1125 (D.C. Cir. 2002) (holding that agencies may not abandon "prior, definitive" interpretations of their own regulations without first engaging in notice-and-comment rulemaking).

Fina argues that the benchmarks should control this case because (1) the Secretary's position—that valuation must equal or exceed the total consideration accruing to the corporate family as a whole—misinterprets the gross proceeds rule and (2) Fina fully discharged its duty to market its production at no cost to the government by selling to FNGC. Defending both of *Texaco*'s rationales, the Secretary argues that the benchmarks are inapplicable because (1) the catch-all gross proceeds provision requires valuation based on total consideration accruing to the corporate family as a whole and (2) Fina's implied duty to market its production at no cost to the government requires valuation based on FNGC's sales, not Fina's.

Beginning with the gross proceeds provision, we of course agree with the Secretary that because the provision applies "[n]otwithstanding any other provision of this section," it trumps any methodology, including the benchmarks, that yields valuations "less than the gross proceeds accruing to the lessee for lease production." 30 C.F.R. §§ 206.152(h) (unprocessed gas), 206.153(h) (processed gas), 206.102(h) (1999) (oil). At this point, however, our agreement with the Secretary ends. As we shall show, the underlying statute's definition of "lessee," the regulation's language and structure, and the agency's own pronouncements at the time of the regulation's promulgation all demonstrate that "gross proceeds accruing to the lessee" refers only to proceeds accruing to Fina, not to the entire corporate family of which Fina is a member.

Reading the Board's decision and the *Texaco* decision that it incorporates by reference, one would never know that the term "lessee"—whose meaning is critical to this case—is defined in both the underlying statute and the MMS's own regulations. FOGRMA section 3(7) defines "lessee" as "any person to whom the United States, an Indian tribe, or an Indian allottee, issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease." Pub. L. No. 97–451 § 3(7), 96 Stat. 2447, 2449 (amended in 1996, after the events at issue in this case, to read "any person to whom the United States issues an oil and gas lease or any person to whom operating rights in a lease have been assigned" and codified at 30 U.S.C. § 1702(7)). The MMS incorporated this definition word for word in both its oil and gas valuation regulations. 30 C.F.R. §§ 206.101 (1988) (oil), 206.151 (1988) (gas). The definition could hardly be clearer. It defines "lessees" not as "person[s] . . . issue[d] . . . leases *and their affiliates*," but rather restricts the definition to "person[s] . . . issue[d] . . . leases." Although the administrative record in this case does not include the actual leases, the "person to whom the United States . . . issue[d] a lease" is clearly Fina. Not only does the Secretary allege no formal relationship between the United States and FNGC, but in its very first paragraph, the Board's decision identifies Fina as the "lessee[ ]/appellant[ ]" and FNGC simply as Fina's "affiliate." *Fina*, 149 I.B.L.A. at 169.

The regulation's overall structure and statements of agency intent at the time of promulgation provide additional reasons why the Secretary's interpretation of the gross proceeds provision is quite wrong. The marketing affiliate provision, which states that "gas which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued . . . based upon the sale by the marketing affiliate," 30 C.F.R. §§ 206.152(b)(1)(i) (unprocessed gas), 206.153(b)(1)(i) (processed gas), shows that the regulation's authors knew just how to require valuations based on downstream resales when they intended such methodology. Moreover, not only did they limit this methodology to marketing affiliates—which FNGC is not—but the regulation contains provisions that expressly deal with valuation of production sold to non-marketing affiliates, *i.e.*, the benchmarks, which provide for valuation based on non-arm's-length transactions, such as intra-corporate transfers.

Removing any doubt about the treatment of sales to non-marketing affiliates, the regulation's preamble makes plain that the decision to restrict valuation based on downstream sales to marketing affiliates was intentional. In response to commenters who proposed expanding the marketing affiliate rule to encompass affiliates who acquire *any* gas from their owners or controllers, rather than affiliates who acquire gas *only* from their owners or controllers, the agency stated that: "The MMS is retaining the term 'only.' 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." Revision of Gas Royalty Valuation Regulations, 53 Fed. Reg. at 1243.

In sum, the overall import of the regulation's tripartite structure and "other indications of the [agency's] intent at the time of the regulation's promulgation," *Gardebring v. Jenkins*, 485 U.S. 415, 430 (1988), is crystal clear. Gas sold directly to unaffiliated entities is valued at the contract price, since that price reliably indicates objective value. In contrast, gas sold to marketing affiliates is valued not on the basis of the initial sale—obviously an unreliable indicator of objective value—but rather on the basis of the price at which it ultimately leaves the corporate family. But the agency expressly restricted non-recognition of intra-corporate sales to situations where no directly comparable arm's-length sales exist. Accordingly, gas sold to non-marketing affiliates—where objective value can be reliably approximated through comparable arm's-length sales—is valued through the benchmarks at the initial sales price and not the subsequent resale price.

As against this clear policy choice enshrined in the regulation, the Secretary takes the exact opposite position. Declining to recognize intra-corporate transfers of gas from Fina to FNGC, even though benchmark comparisons exist, the Secretary argues that Fina should calculate value as if FNGC were a marketing affiliate, *i.e.*, on the basis of downstream resales. At oral argument, we asked counsel for the Secretary to explain why this interpretation did not read the benchmarks out of the statute—that is, if non-marketing affiliates are treated just like marketing affiliates, what purpose do the benchmarks serve? Although it is true, as counsel responded, that the benchmarks would still apply to non-marketing affiliates selling gas downstream for less than the price at which they bought it, Oral Arg. Tr. 15:6–16, nothing in either the regulation or its preamble suggests that the benchmarks cover only the limited subset of non-marketing affiliates who fail to turn a profit.

Moreover, the Secretary's interpretation would ripple through other parts of the regulation that use the term "lessee," creating several linguistic absurdities. For instance, the first benchmark for valuing gas sold to non-marketing affiliates is defined as "gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract." 30 C.F.R. §§ 206.152(c)(1) (unprocessed gas), 206.153(c)(1) (processed gas). Under the Secretary's interpretation of "lessee," this phrase would make no sense. If "gross proceeds accruing to the lessee" refers to total proceeds accruing to corporate families, then as a logical matter no gross proceeds can accrue to lessees pursuant to purely intra-corporate "non-arm's-length contract[s]."

The regulation's definition of "marketing affiliate"—"an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production," 30 C.F.R. § 206.151—illustrates the same point. If affiliates *are* lessees then it makes no sense to talk about an "affiliate of the lessee" nor of affiliates acquiring lessees' production.

In still a third example, the preamble's explanation of the marketing affiliate rule refers to the "gross proceeds accruing to the lessee *from its affiliate*." Revision of Gas Royalty Valuation Regulations, 53 Fed. Reg. at 1243 (emphasis added). In addition to implying that lessees and affiliates are distinct entities, this phrase completely contradicts the Secretary's position that producers like Fina cannot accrue gross proceeds from their affiliates, such as FNGC.

In *Texaco*, the Secretary warned that valuing production based on intra-corporate sales "allows any lessee to avoid the gross proceeds requirement by the simple and facile device of creating a wholly-owned subsidiary and then first transferring the production to the affiliate, for a price the lessee determines unilaterally, before selling the production at arm's length at a higher price." *Texaco* at 7. We disagree. Even Fina's position would not allow it to set prices "unilaterally," for the benchmarks require Fina to base value on the prices that its affiliate, FNGC, pays *other* producers. In other words, Fina must pay royalties based on the actual market value of the gas at the time Fina transfers the gas to its affiliate.

Although the Secretary does not expressly say so, her primary concern seems to be that valuing the gas based on the initial sale would allow Fina and other lessees to pay royalties on gas before its value increases through the transportation and marketing services provided by affiliates like FNGC. But this is precisely what the regulation permits. If the Secretary now believes—as *Texaco* and her position here indicate—that recognizing intra-corporate transfers is too favorable to producers, she should amend the regulations through notice-and-comment rulemaking, not under the guise of interpretation.

The Secretary's second ground for rejecting application of the benchmarks requires little discussion. The regulation states that "lessee[s] [are] required to place gas in marketable condition at no cost to the Federal Government ... unless otherwise provided in the lease agreement," 30 C.F.R. §§ 206.152(i) (1996) (unprocessed gas), 206.153(i) (1996) (processed gas), with "marketable condition" meaning fit for "accept[ance] by a purchaser under a sales contract typical for the field or area," *id.* § 206.151. Acknowledging that we have previously interpreted this provision to mean that only producers who market gas downstream, not producers who "opt to sell at the leasehold," must pay royalties based on the increase in gas value associated with marketing expenditures, *Indep. Petroleum Ass'n v. DeWitt*, 279 F.3d 1036, 1041 (D.C. Cir. 2002), the Secretary argues that "Fina did market its production downstream, through its affiliate FNGC," Appellee's Br. at 46. This argument, however, differs not at all from the Secretary's basic position against recognizing intra-corporate sales for valuation purposes—a position that, as we have just explained, conflicts with the regulation's plain language.

The judgment of the district court is reversed.

*So ordered.*

## Ten Principles of Marketable Condition and Transportation

(As suggested in presentation at Rocky Mountain Mineral Law Foundation Institute, 12 Feb 2004)

1. The mere fact that gas is sold untreated does not mean that it is in marketable condition.

2. The fact that a conditioning function makes gas <u>transportable</u> does not mean that the cost is a transportation cost.

3. Simply because gas has been gathered to the approved central accumulation point does not mean that the gas is in marketable condition in all respects or that all costs incurred downstream of that point are deductible. Costs necessary to put production into marketable condition are not deductible as transportation costs, regardless of where the conditioning function is performed.

4. A lessee cannot avoid the marketable condition requirement, or effectively deduct the costs, by transferring a conditioning function to a purchaser, affiliate, etc. (and accepting a lower price). Costs necessary to put production into marketable condition are not deductible as transportation costs, regardless of who performs the conditioning function.

5. Lessee does not have to put production into marketable condition more than once or condition production <u>beyond</u> pipeline requirements at its own expense.

6. Performing conditioning functions in multiple steps or phases does not make costs deductible as transportation costs.

7. Generally, the processes that are necessary to put gas into marketable condition are those that allow the gas to be marketed through a standard high-pressure pipeline. If a lessee is going to claim that a particular treatment function is not necessary to put production into marketable condition, the lessee must show that there is a real and active commercial market for the gas in that condition without that treatment function.

8. There may be multiple markets for gas produced from a particular area that may call for different degrees of conditioning. If one market requires a lower pressure or other quality requirements than another, that does not mean that meeting the requirements for the market that requires the lowest quality (the "lowest common denominator" market) makes all the gas marketable. Gas may be in marketable condition for one market but not for another. Condition it to the quality required for the market it serves.

9. It is not necessary for the <u>sales</u> contract to state all the specifications and limits for pressure, water content, and acid gases — the quality required for the pipeline that transmits the gas to the market is the required quality.

10. The reference in the definition of "marketable condition" in 30 C.F.R. §§ 206.151 and 206.171 to a "sales contract typical for the field or area" is not limited to contracts for sales that occur in the field or area. It includes contracts for sales in downstream markets.

**Indian Gas – special considerations under the current Indian gas rule:**

On slide 9, we said that, per the Fina decision, the value for royalty purposes is no less than the lessee's gross proceeds under its NAL contracts, less applicable allowances, not the wholly-owned or wholly-commonly owned affiliate's AL resale price.

However, the current Indian gas rule, at 30 CFR 206.174(g) states:

> *Minimum value of production.* (1) For gas, residue gas, and gas plant products valued under this section, under no circumstances may the value of production for royalty purposes be less than the gross proceeds accruing to the lessee (including its affiliates) for gas, residue gas and/or any gas plant products, less applicable transportation allowances and processing allowances determined under this subpart.

The Indian gas rule defines an arm's-length contract as follows (30 CFR 206.171):

> *Arm's-length contract* means a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. (Emphasis added)The following percentages (based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership) determine if persons are affiliated:
>
> (1) Ownership in excess of 50 percent constitutes control.
>
> (2) Ownership of 10 through 50 percent creates a presumption of control.**
>
> (3) Ownership of less than 10 percent creates a presumption of noncontrol which MMS may rebut if it demonstrates actual or legal control, including the existence of interlocking directorates.
>
> Notwithstanding any other provisions of this subpart, contracts between relatives, either by blood or marriage, are not arm's-length contracts. MMS may require the lessee to certify the percentage of ownership or control of the entity. To be considered arm's-length for any production month, a contract must meet the requirements of this definition for that production month as well as when the contract was executed.

** Note that the NMA decision applies here and ownership of 10-50% presumes non control.

So, for Indian gas not in an index zone, under the current Indian gas rule, the minimum value of production may include the affiliate's resale gross proceeds, if the two parties to the contract are affiliates based on percentages of ownership.

For example, assume that MMS has determined that the contract between XYZ Producing and XYZ Marketing is non-arm's-length because XYZ Producing owns 75% of XYZ Marketing and because there is no opposing economic interest between the two parties. For Indian gas the minimum value may include the gross proceeds accruing to XYZ because of the language in 206.174 (g).

## 4.1.2 Valuation of unprocessed gas not sold under an arm's-length contract

Unprocessed gas that is not sold under an arm's-length contract is valued under the benchmark system (30 CFR 206.152(c) and 30 CFR 206.172(c)). The benchmark system governs the valuation of unprocessed gas under any of the following three conditions:

- The gas is sold under a non-arm's-length contract;
- The gas is transferred without a contract; or
- The gas is sold or disposed of under an arrangement that does not meet the criteria for valuation under an arm's-length contract.

The disposition of unprocessed gas under any of these conditions is referred to as non-arm's-length.

The benchmark system for valuing unprocessed gas under non-arm's-length conditions consists of three prioritized benchmarks. Value is based on the first benchmark that is applicable to the lessee's situation. If the first benchmark does not apply or cannot be used, the lessee must use the second benchmark to determine value. This process is continued through the third benchmark. Value can never be less than the gross proceeds accruing to the lessee for sales under a non-arm's-length contract (30 CFR 206.152(h) and 30 CFR 206.172(h)).

For all value determinations under the benchmark system, the lessee must retain all relevant data (30 CFR 206.152(e)(1) and 30 CFR 206.172(e)(1)).

### 4.1.2.1 First valuation benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable arm's-length contracts

Under the first benchmark, the gross proceeds accruing to the lessee under its non-arm's-length contract are acceptable for royalty value, provided those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality gas from the same field (30 CFR 206.152(c)(1) and 30 CFR 206.172(c)(1)). If transactions for production from the same field do not provide a reasonable sample of arm's-length values, the surrounding area should be used.

**Equivalency**. The lessee's non-arm's-length gross proceeds are considered equivalent if they are not less than the gross proceeds derived from or paid under the most comparable arm's-length contract in the same field (or area) for like-quality gas.

**Comparability**. Use the following factors to evaluate comparability of arm's-length contracts:

- Price
- Duration of the contract
- Market(s) served
- Terms
- Quality of gas
- Volume
- Other appropriate factors

Lessees must use the most comparable arm's-length contract to determine value. For example, a 5-year sales contract for a large volume of unprocessed gas delivered to a distant utility company is not comparable to a monthly interruptible sales contract covering a small volume of unprocessed gas sold in the field.

**Gross proceeds.** The lessee's gross proceeds for unprocessed gas sold under a non-arm's-length contract include all consideration paid directly or indirectly under the contract, the same as under arm's-length contracts. However, the gross proceeds under a non-arm's-length contract cannot be reduced by a transportation factor (see "Transportation factors" on p. 4-12 for an explanation of a transportation factor). If the lessee's proceeds under its non-arm's-length contract are reduced by the costs of transportation, the transportation reduction must be added to those proceeds to determine value for royalty purposes. The lessee may, however, receive an allowance for its actual transportation costs.

#### 4.1.2.2 Second valuation benchmark: Other relevant information

The second benchmark is used if the lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable arm's-length contracts, or if no comparable arm's-length contracts exist in the field or area. The second benchmark is also applicable when the lessee receives no consideration for the disposition of its gas, as in cases of waste or avoidable loss. Under this benchmark, the lessee must consider other information that is relevant or would be used in valuing like-quality gas in the field or area (30 CFR 206.152(c)(2) and 30 CFR 206.172(c)(2)), including:

- The gross proceeds under arm's-length contracts in the field or area;
- Published prices for unprocessed gas;
- Prices for arm's-length spot sales of unprocessed gas;
- Other reliable public sources of price or market information; or
- Other information relevant to the particular lease operation or the salability of the lessee's gas.

The lessee must select the method that best determines the value of the lessee's unprocessed gas. The selected criterion should either:

- Reflect most closely the circumstances surrounding the disposition of the lessee's unprocessed gas, or
- Be the most relevant factor in valuing the lessee's unprocessed gas.

For example, if comparable arm's-length contracts exist in the field or area as required under the first benchmark, but the lessee's gross proceeds are less than the gross proceeds under those contracts, the gross proceeds under the most comparable arm's-length contracts would be used to establish value. If no arm's-length contracts exist in the field or area, published prices, adjusted for quality and transportation, may be the best determinant of value. Or, other factors, such as weighted-average prices, contractually reduced prices for transportation, or certain non-arm's-length contract prices may be used in establishing value.

Published prices and spot market prices for unprocessed gas may be obtained from natural gas periodicals such as *Natural Gas Intelligence, Natural Gas Week*, *Inside F.E.R.C.'s Gas Market Report*, and other similar publications.

#### 4.1.2.3 Third valuation benchmark: Net-back or other reasonable valuation method

The third benchmark for valuing unprocessed gas is the net-back method or any other reasonable method for valuation (30 CFR 206.152(c)(3) and 30 CFR 206.172(c)(3)). This benchmark is used to determine value if there are no other factors relevant in valuing like-quality unprocessed gas in the field or area. Because the circumstances regarding the use of a net-back or other method cannot be foreseen, no instructions are provided in this handbook. The acceptability of such methods is determined solely on the merits of each method on a case-by-case basis.

Figures 4-13 through 4-20 illustrate valuation of unprocessed gas not sold under arm's-length contracts. Values reported on Form MMS-2014 are shown in boxes.