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Book 1

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TABLE OF CONTENTS

What's Behind the Valuation Controversy Anyway? Paper 1

DAVID E. PIERCE, Professor of Law, Washburn University School of Law, Topeka, Kansas

The "Duty to Market" Downstream at No Cost to the Lessor (The Alleged Federal "Duty to Market") Paper 2A

JUDITH M. MATLOCK, Attorney, Davis, Graham & Stubbs LLP, Denver, Colorado

The Lessee's Duty to Market at No Cost to the Lessor Under Federal and Indian Leases — Paper 2B

GEOFFREY HEATH, Assistant Solicitor for Royalty and Offshore Minerals, Office of the Solicitor, Department of the Interior, Washington, D.C.

The Duty to Market Under Federal and Indian Leases: It's Only Money — Paper 2C

THOMAS H. SHIPPS, Attorney, Maynes, Bradford, Shipps & Sheftel, LLP, Durango, Colorado

The New Indian Gas Valuation Rule-- MMS Perspective — Paper 3A

THERESA WALSH BAYANI, Chief, Oil and Gas Valuation Branch, Royalty Valuation Division, Minerals Management Service, Denver, Colorado

The New Indian Gas Valuation Rule-- An Audit Perspective — Paper 3B

PERRY SHIRLEY, Assistant Director, Minerals Department, Division of Natural Resources, The Navajo Nation, Window Rock, Arizona

Treatment of Product Exchanges and Buy-Sell Contracts Under the Department of Interior Valuation Regulations — Paper 4A

KENNETH R. VOGEL, Chief, Office of Enforcement, Royalty Management Program, Minerals Management Service, Denver, Colorado

Industry View — Paper 4B

L. POE LEGGETTE, Attorney, Fulbright & Jaworski L.L.P., Washington, D.C.

Treatment of Product Exchanges and Buy-Sell Contracts Under the Department of Interior Valuation Regulations

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Paper 4A

Regulatory Framework

Background

The Secretary of the Interior has the power to set the value of crude oil produced from federal or Indian oil and gas leases. For the period under consideration in this paper, the Secretary exercised that discretion by promulgating regulations. For oil produced from federal or Indian leases during the period prior to March 1, 1988, the regulations were found at 30 C.F.R. § 206.103 (1987) for onshore leases and § 206.150 (1987) for offshore leases. For onshore leases, the regulations set "[t]he value of production, for the purpose of computing royalty" for onshore leases to be:

> The estimated reasonable value of the product determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production ... be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable basis as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel ... paid or offered at the time of production in a fair and open market for the major portion of like-quality oil ... produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. 30 C.F.R. §206.103 (1986).

The section applicable to offshore leases is similar. It sets the value of production from leases on the outer continental shelf as "never ... less than the fair market value." It continues:

> The value used in the computation of royalty shall be determined by the Director. In establishing value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the same field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary. 30 C.F.R. § 206.150 (1986).

While the regulations in effect for production prior to 1988 allow considerable discretion, they both require a value based on the higher of proceeds ("gross proceeds") or market ("market value" or "highest price paid for a major portion"). Unlike private leases, which usually either provide for the payment of royalty based on market value or proceeds, the regulations applicable to federal and Indian leases generally provide for value to be based on the higher of the two.

The codified regulations were supplemented by Notices to Lessees published by the Conservation Division of the U.S. Geological Survey (USGS), the predecessor agency to the Minerals Management Service (MMS). In particular, USGS published a Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL-1) (February 1, 1977), and a Notice to Lessees and Operators of Indian Oil and Gas Leases (NTL-1A) (April 1, 1977).

In NTL-1, the Conservation Division delegated the authority to value crude oil to the Regional Supervisor.[1] It limited that authority to the same factors listed in the regulation above. During a period when the price of crude oil was regulated, it required the value be at least "gross proceeds accruing to the operator" or "the highest price legally obtainable for production from the lease." Like the rules that follow, the NTL allowed an application for the establishment of royalty value, submitted by each operator and working interest owner. The application was required to be "accurate and complete." Failure to file an accurate and complete application would "result in the Supervisor establishing a royalty value equal to the highest price paid for like quality production in the field or area, assessing liquidated damages, or taking other appropriate action to bring about compliance."[2]

During the 1980s, after the formation of the MMS, the Department of the Interior (Interior) promulgated new valuation regulations for the valuation of crude oil. The process took many years while Interior worked with interested parties: including States and Indians that either share in Federal royalties (States) or are the beneficial owners of the royalty estate (Indians); oil producing companies, which are lessees of Federal and Indian leases; and Congressional committees. The final rule was published in January 1988 and was effective for production beginning March 1, 1988.

Interior explained that the purpose of the new regulations was to clarify and simplify the payment of royalties. As MMS stated when it published the regulations:

> The MMS is revising the current regulations regarding the valuation of oil to accomplish the following: ...
>
> (4) Clarification that royalty is to be paid on all consideration received by lessees, less applicable allowances, for lease production.
>
> (5) Creation of regulations to guide the lessee in the determination of allowable transportation costs to aid in the calculation of proper royalty due the lessor.

53 FR 1184 (Jan. 15, 1988).

The rules also were intended to base value for royalty purposes on the market value of the product exchanged in a free and open market between a willing buyer and a willing seller. They had two basic propositions: (1) for transactions that were arm's-length trans-

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[1] p.5
[2] p.6

actions between a willing buyer and a willing seller, value was generally to be the "gross proceeds accruing to the lessee,"[3] and (2) for other transactions, value was to be based on a series of benchmarks, each of which was meant to approximate the market value.[4]

Under the first principle, "gross proceeds" are given an expansive meaning in the regulations, which follows the gloss given to the term under the previous set of regulations.[5] The expansive meaning of gross proceeds has been repeatedly upheld in litigation.[6] In addition, Interior explained that in determining what was gross proceeds, MMS would "examine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the oil." If there was additional consideration, there were two possible outcomes. Either MMS could add the other consideration to the contract price to reach the total consideration, or MMS could require the production to be valued according to the benchmarks.[7] Interior explained in the preamble to the rule that if total consideration could be valued, that would be used to measure the gross proceeds, otherwise, the benchmarks could be used. Interior determined that a lessee must use the second through fifth benchmarks if the contract did not reflect reasonable value due to misconduct between the parties, or because the lessee had breached its duty to the lessor to market the production for their mutual benefit.[8]

Second, for dispositions other than sales at arm's-length,[9] value was to be based on a series of benchmarks, which the lessee was expected to apply. The lessee was required to use the first applicable of the benchmarks. A lessee must follow the benchmarks in lexicographic order. The first one must be followed before the second may be used, etc. Each benchmark is intended to mimic either the gross proceeds or the market value of the oil (or both). The first benchmark is the one that MMS expected to be followed the most often. It requires the lessee to value the oil that must be valued under a benchmark (either non-arm's-length dispositions, or dispositions for which additional consideration was received, but which would not be valued under (b)(1)(ii)) by the lessee's actual arm's-length transactions. More particularly, this benchmark requires the lessee to use the weighted average of all its arm's-length sales and purchases, whether sold or purchased

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[3] See 30 C.F.R. §206.102(b) (1989).

[4] See 30 C.F.R. §206.102(c) (1989).

[5] *Gross Proceeds* (for royalty pay payment purposes) means the total moneys and other consideration accruing to an oil and gas lessee for the disposition of the oil produced. 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. Gross proceeds, as applied to oil, also includes, but is not limited to, reimbursements for harboring or terminaling fees. Tax reimbursements are part of the gross proceeds accruing to the lessee even though the Federal royalty interest may be exempt from taxation. 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 reasonably efforts are also part of gross proceeds. 30 C.F.R. §206.101 (1989).

[6] See *Hoover &Bracken Energies, Inc. v. Dept. of the Interior*, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984); *Pennzoil Exploration and Production Co. v. Lujan*, 928 F.2d 1139 (TECA 1991); *Marathon Oil Co. v. U.S.*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940 (1987); *Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212 (5th Cir. 1992), *cert. denied*, 510 U.S. 813 (1993); United States v. Century Offshore Management Corp., 111 F.3d 443 (6th Cir. 1997), *cert. denied*, 118 S.Ct. 880 (1998).

[7] "If the contract does not reflect the total consideration, then the MMS may require that the oil sold pursuant to that contract be valued in accordance with paragraph (c) of this section. Value may be not be less than the gross proceeds accruing to the lessee, including the additional consideration." 30 C.F.R. § 206.102(b)(1)(ii) (1989).

[8] See 30 C.F.R. § 206.102(b)(1)(iii) (1989).

[9] Or under the conditions when b(1)(ii) or (iii) apply as explained above.

under sales contracts or posted prices, to value to other oil in the same field or from the same area for which benchmark valuation applies. The value must also be comparable to other people's posted prices used in arm's-length transactions or other people's arm's-length contract prices.

The second benchmark would then require a lessee to use the arithmetic average of other person's contemporaneous posted prices *actually used in arm's-length transactions* in the same field or from the same area. The third benchmark requires the lessee to use the arithmetic average of other person's arm's-length contract prices. The fourth benchmark requires the lessee to propose a method that uses arm's-length spot prices from the same field or area or other relevant matters. The fifth benchmark requires the lessee to use a net-back method or other reasonable method to compute value.[10] It is important to note that the rules also make it clear that the meaning of lessee for these rules is either the actual lessee or its affiliate or agent that provides marketing services for the lessee.[11]

It is important to note that while industry commenters referred to the benchmark system as one based on posted prices, MMS did not simply accept any posted price, but insisted that the lessee use its posted prices (and other contract sales and purchases) *only* if they were used in arm's-length contracts (involving significant quantities of production from the field). For example one industry commenter declared that they:

> strongly support the adoption of clear and consistent standards of valuation for royalty oil based upon the true value of the product—the price received in the marketplace for the sale of that oil. The valuation proposal ... recognizes the interaction of competing market forces and recognizes that a seller of oil will normally negotiate the best deal it can to further its own interests. The use of a price that is generally available to all sellers is a much more reasonable approach

[10] (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:

(1) 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); 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). In evaluating the comparability of posted prices or oil sales contract prices, the following factors shall 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. 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;

(2) 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);

(3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby areas;

(4) 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;

(5) A net-back method or any other reasonable method to determine value;

30 C.F.R. § 206.102(c) (1989).

[11] (6) For purposes of this paragraph, 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 C.F.R. § 206.102(c)(6).

> to the determination of 'value' for a given supply of oil than the arbitrary selection of a price that one seller may have received under circumstances that do not include all sellers. Where an arm's-length contract does not exist, the benchmark system of valuation permits an objective procedure for arriving at the valuation based upon posted prices which have been the basis for sales of oil for many years.[12]

Another industry commenter supported both the benchmarks and their prioritization because both add certainty to valuation determinations. Also, the use of the lessee's contemporaneous posting provides a .benchmark valuation for many major producers." MMS on the other hand limited when posted prices would be applicable:

> The benchmarks are primarily based on posted prices which are the normal basis for oil sales and which reflect the price of oil in a free and open market. Posted price information for significant quantities of like-quality oil sold from a field or area will normally be available. The addition of § 206.102(d) will permit necessary information on arm's-length sales to be obtained.[13]

MMS also intended for the regulations to be implemented by the lessee. MMS explained in the preamble, in response to a state commenter who wanted to know how to administer the prioritized benchmark system, that MMS would "require that the lessee make a reasonable effort to apply a benchmark before proceeding to the next. Auditors must be satisfied that lessee information is sufficiently accurate and complete to implement a benchmark. The addition of § 206.102(d), whereby lessees must provide arm's- length sales and volume information, will assist in the enforcement of these 'comparability' requirements. It would be impossible for MMS to attempt to implement a procedure where government has to make all the decisions. Such a procedure would impose a tremendous administrative burden which would be very costly."[14]

The regulations also place the burden on the lessee to demonstrate that it has met the requirements of the benchmarks by requiring the lessee to retain all records used to determine value under them. In addition, a lessee may only use the first three benchmarks without notifying MMS in advance.[15]

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[12] 53 FR 1184, 1202 (January 15, 1988).

[13] *Id.*

[14] 53 FR 1184, 1201 (January 15, 1988).

[15] (e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(4) or (c)(5) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(4) or (c)(5) of this section and each time there is a change from one to the other of these two methods. 30 C.F.R. § 206.102(e).

Gross Proceeds

As mentioned above, the MMS and the USGS have traditionally had a very broad view of the meaning of gross proceeds. That view is that anything that accrues to a lessee related to the production of lease product is royalty bearing. In addition, gross proceeds is the minimum value, regardless of what other valuation principles may apply. 30 C.F.R. § 206.102 (h).

Types of Sales and Purchases

When oil producer or its affiliate buys or sells crude oil from a lease or area it may use several contractual mechanisms. The two most common are outright sales and purchases and buy-sell or exchange contracts. The outright sale or purchase is the simplest. In it a seller (often the operator or lessee on an oil and gas lease) will sell its production to another party (usually either a transporter, a marketer or a refiner)[16] for a price. That price may be with reference to a posted price, a price set by the contract or a price with reference to some other known price. At the time the 1988 regulations were promulgated, the industry commenters repeatedly made the assertion that posted prices were the prices *used* in the vast majority of sales of oil from Federal and Indian leases.

For example: "One industry commenter noted that 'This ordering of the benchmarks is the result of extensive public comment which showed that, for valuation of oil, posted prices should be moved closer to the top of the hierarchy insofar as posted prices account for the vast majority of oil transactions.'"[17]

Based on all the input MMS received, MMS did assume that in fact the vast majority of oil transactions were at posted prices. However, very few true arm's-length sales involving major oil producers have occurred at posted prices since the promulgation of the current valuation regulation. Rather for transactions that are outright sales—where the seller disposes of the oil and receives only cash consideration, most occurred at a premium to posted prices.

In addition to outright sales, the major oil producing lessees often (in fact, usually) disposed of oil by selling it and receiving in consideration both a cash price (that may or may not actually be paid) plus other oil at another location at a fixed price. Sometimes the prices set in this transaction do not reflect the actual value or total consideration and additional consideration is received in the form of the other oil. If the prices set are equal to the market value then the prices would equal the total consideration. For example, let us assume the market value of Light Louisiana Sweet (LLS) oil at St. James, Louisiana in the sales month was $20.00 per barrel and the market value of West Texas Intermediate

[16] Crude oil eventually is refined (into gasoline, diesel, jet fuel, heating oil, etc.), so virtually all crude oil eventually is transferred to a refiner.
[17] 53 FR at 1202.

(WTI)at Cushing, Oklahoma was $20.50 per barrel.[18] If Seller A sold 1000 barrels of LLS produced from Federal leases offshore Louisiana for $19.90 at a point of sale at the first onshore delivery point (upstream from St. James) and Seller B (who bought the LLS from A) sold A WTI at Cushing for $20.50, the $19.90 would represent the total proceeds for the Federal oil.

On the other hand, if the LLS was sold for $17.50 at the first onshore delivery point, and the WTI was sold for $18.10 at Cushing, the total consideration received would include additional consideration received from the right to buy the WTI at less than market value. The additional consideration would be the value of the oil received ($20.50 for WTI) less the price paid for the oil ($18.10 for WTI). That difference ($2.40) would then be added to the cash price received for the LLS ($17.50) to get a total value of $19.90. Another way to look at this would be to take the value of the oil eventually received ($20.50 for WTI) and subtract the location differential in the "buy-sell" or "exchange" agreement ($18.10-$17.50=$0.60). This also results in a total consideration of $19.90.

MMS has not always realized how to treat these agreements because it believed that posted prices were the value used in "the vast majority of oil transactions". A review of that treatment is necessary to understand how a lessee should have applied the first benchmark (given that the lessees knew that the value of oil sold through a buy-sell was the total consideration as explained above).

Treatment of Buy-Sell or Exchange Agreements

As MMS traditionally believed that posted prices were the value received in arm's-length transactions and were also therefore market value there are relatively few MMS orders involving crude oil. It was the practice of auditors to only test whether a lessee had valued the oil at a price equal to the posted price and not test further.[19] Perhaps the earliest treatment of exchange agreements by MMS came in a Director's decision[20] involving Cities Service Oil and Gas Corporation. This decision was issued for production subject to the pre-1988 regulations. In the transaction considered there, Cities Service sold oil it produced from federal leases in North Dakota to Amoco. It purchased a like volume of oil from Amoco near Cities' Lake Charles, LA refinery. Cities declared that its purpose was to "ensure a supply of crude for [its] refinery." MMS declined to accept this agreement, which it called an exchange (based on the definition in Williams & Meyers, Manual of Oil and Gas Terms (1976)), as an arm's-length sale. The Director concluded:

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[18] Light Louisiana Sweet (LLS) and West Texas Intermediate (WTI) are commonly traded oil types. WTI is the most commonly traded and is the basis for the futures market on the NYMEX exchange. LLS is one of the most commonly traded oils produced from the Gulf of Mexico and as the vast majority of oil produced from Federal leases is produced in the Gulf of Mexico, it is a very common Federal crude type.

[19] *See* Kenneth Moyers Deposition, in *U.S. ex rel Johnson v. Shell Oil Co. pending before* (E.D.Tex.) *passim.*

[20] The administrative appeals process involving royalty appeals is a two-stage process. After an MMS official (usually an audit manager) issues an order, that order may be appealed first to the MMS Director. The Director decides (in a somewhat informal proceeding in which there are no rules concerning *ex parte* communications) the case as a first matter. Most cases are not further appealed. However an appellant has the right to appeal next to the Interior Board of Land Appeals (IBLA), whose decision is the final agency action for the Department of the Interior.

> ... the Appellant did not sell the crude oil pertaining to this appeal in a simple sale to a third party that could presumptively establish the fair market value. ... In the simplest exchange the parties could exchange barrels of crude oil without even assigning a sales price to either the crude oil sent or crude oil received. ... even though the parties may exchange invoices, the prices assigned to the crude oil may not be equivalent to the fair market value. The parties can assign prices that are half the market value as long as there is a reciprocal undervaluation ... In short, the price used in an invoice for exchanged crude oil, even between unrelated oil companies, is not necessarily the fair market value of the crude oil.

MMS-86-0538-O&G (1987). (June 12, 1987).

MMS believed the posted price, which was greater than the invoice price, was more representative of the fair market value and therefore ordered Cities to pay on the basis of the Amoco posting for North Dakota sweet. Looking at this early decision from the perspective of the language used in the 1988 rules, MMS determined that in a buy-sell or exchange, the stated invoice price did not necessarily reflect the total consideration accruing to the lessee.

MMS began the process of explaining how to look at exchange agreements under the 1988 regulations in the preamble to the final rule. The regulations were drafted with the intent of moving to a gross proceeds focus.[21] In addition, gross proceeds was to be given a broad interpretation, capturing all consideration received for the disposition of oil even if the consideration was expressed in non-monetary terms.

In response to a comments that "For example, a lessee may accept a lower price for its production from a Federal lease for the opportunity to sell to the particular purchaser its production from other leases."[22] MMS responded:

> Lessees cannot avoid their royalty obligations by keeping a part of their agreement outside the four corners of the contract. Moreover ... many commenters stated that the "total consideration" concept properly belonged as part of gross proceeds, not in the definition of arm's-length contract. Therefore, MMS purposefully has drafted the gross proceeds definition to be expansive and thus include all types of consideration flowing from the buyer to the seller. Toward that end, MMS has replaced the word "paid" used in the first draft final rule with the term "accruing." There may be certain types of consideration which are not actually paid by the buyer to the seller, but from which the seller benefits. The term "accruing" ensures that all such consideration is considered gross proceeds.[23]

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[21] The preference for looking at actual arm's-length transactions is reflected in MMS's rejection of the suggestion by Robert Berman of the DOI's Office of Policy, Budget and Administration that oil transferred at less than arm's-length be valued according to transactions for crude oil futures on the New York Mercantile Exchange (NYMEX). *See* Berman, "Crude Oil Royalty Valuation Monitoring System" (1986) (RVD031-0008), Associate Director for Royalty Management, "Review of Analysis Titled Crude Oil Royalty Valuation Monitoring System," by Bob Berman, Policy, Budget and Administration" (1987) (RVD0031-0029).

[22] 53 FR at 1194.

[23] *Id.* at 1194-95

ARCO Valuation Determination

Soon after the 1988 rules were promulgated, ARCO requested that MMS consider certain types of related transactions to determine how to value the oil. ARCO presented a transaction in which it delivered federal oil to St. James, Louisiana, which it sold. It received the same quantity of oil from the purchaser of the Federal oil, but at Cushing, Oklahoma. MMS wrote back to ARCO in a valuation determination letter that it considered the sale at St. James to be the only transaction that mattered for valuation. As ARCO and the purchaser were unrelated, gross proceeds would only relate to its sale of the Federal oil. "Any benefits accruing to [the lessee] that result from the receipt of oil from the second party will not be viewed as a portion of [the lessee's] gross proceeds or total consideration received within the meaning of 30 C.F.R. §§ 206.102(b)(1)(ii) and 206.102 (h)."[24]

This letter is inconsistent with the Director's decision in *Cities, supra,* on two grounds. First, it decided that a buy-sell arrangement was an arm's-length contract. Second, it decided that the consideration transferred at the first sales point (the point at which the Federal oil was sold) was the only consideration that mattered for Federal valuation purposes. As there was no discussion that the 1988 regulations had changed the meaning of the valuation system on such a fundamental point, this private letter could just be dismissed as being inconsistent with the stated policy of the Service, and therefore only applicable (if at all) to the person to whom it was written.

Yet, in some ways the letter does properly articulate the issue in a more sophisticated language than the Director. However, in other ways the letter fails to mention the bases for its conclusion. It is clear that the letter is correct in determining that the contract between ARCO and its purchaser was arm's-length. What the Director held, in *Cities*, was that the sell side of buy-sell transactions should be treated as not being arm's-length. The new regulations specified the conditions when a contract between two unrelated parties could be treated as less than arm's-length. In 30 C.F.R. §§ 206.102(b)(1)(ii), when there is additional consideration that cannot be valued, MMS may require that the lessee use the benchmarks.

On the other hand, for the letter to state that only the value stated in the first side of the transaction mattered was either written in ignorance of the *Cities* decision and the preamble (and logic), or, more likely, it simply failed to carefully articulate the principle of all valuation determinations: that they only apply to the facts presented by the party seeking the guidance. In this case, the analysis was based on the understanding from ARCO that the value received for selling its Federal oil at St. James was market value.[25] Otherwise, in addition to being inconsistent with the Director's decision, which was binding on the Division Chief, the determination is illogical and inconsistent with the plain language of the regulations requiring value to be equal, at a minimum, to the total consideration received.

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[24] Dial, Royalty Valuation and Standards Division, Valuation Determination Letter for ARCO (March 3, 1989).
[25] *See* depositions of Milt Dial and Don Sant, in *U.S. ex rel Johnson v. Shell Oil Co.*.

Suppose that the market value of oil at St. James in April 1989 was $25.00. If ARCO's contract sold the oil for $25.00 and received back oil at Cushing for the market value there, then the RVSD determined it would be irrelevant what ARCO did with the oil. As the letter stated, MMS was not looking for what happened in those downstream transactions. Whether ARCO made a profit or a loss on its resale of the Cushing oil, whether it sold for cash immediately or held for a period and speculated or whether it used the futures market, MMS determined it would not chase that resale of oil.

On the other hand, had ARCO's contract provided for a sale of St. James oil at $5.00, and a purchase of oil at Cushing at $20.00 less than market value, the RVSD would not have determined that $5.00 was the gross proceeds for the sale. Rather it would have been forced to follow the decision in *Cities* and determine that another method must be used. In that case it could have either used benchmarks, or following the choice in 206.102(b)(1)(ii) if the total consideration could have been measured, it could have used the total consideration. Due to 206.102(h)[26], the total consideration method (if it can be used) must be used to determine a *minimum* value.

As MMS noted in the preamble to the oil rule:

> In response to those commenters who believed that parties to an arm's-length contract must have adverse economic interests, MMS included in the first draft final rule definition a provision which requires that to be arm's-length a contract must reflect the total consideration actually transferred from the buyer to the seller, either directly or indirectly. For example, if the parties to the contract agreed that the price for oil from a Federal or Indian lease will be reduced in exchange for a bonus price to be paid for other production from a fee lease, MMS would not treat that contract as arm's-length.[27]

While the RVD Chief did not state the premise on which the ARCO letter was written, the only legally consistent interpretation is the one states by him in the deposition: that acceptance of the first leg of the transaction as capturing all the consideration depends on believing that it is at market value and the repurchase is at market value. In fact, when the ARCO determination was applied in a further valuation determination issued to Freeport-McMoRan, RVSD stated that the ARCO letter stood for the proposition that:

> Production is considered sold when (1) it is delivered to the purchaser, (2) the title is transferred, and (3) actual consideration *reflecting the value of the production* is received.[28]

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[26] 30 C.F.R. § 206.102(h) requires that value never be less than the gross proceeds accruing to the lessee.
[27] 53 FR at 1192.
[28] Dial, Royalty Valuation and Standards Division, Valuation Determination Letter for Freeport-McMoRan (May 18, 1992). *See also* Gibbs Tschudy, Royalty Valuation and Standards Division, Valuation Determination Letter of AGIP (November 13, 1992); Gibbs Tschudy, Valuation Determination Letter for Samedan Oil Co, (June 19, 1995).

Payor Handbook

MMS did not apparently make this condition clear when it published the *Oil and Gas Payor Handbook Volume 3* (1993). In that document, MMS stated that for exchange agreements where the intent is to transfer title and consideration is paid, value is determined at the first point of sale for exchange agreements. The value is then determined by the arm's-length or non-arm's-length rules as appropriate.[29] This is completely consistent with all other pronouncements on the matter. However, in attempting to explain the rule in a diagram, MMS neglected to include the condition highlighted above. In Figure 3-14, MMS explained that if the lessee sold production through such an exchange agreement for $23.35 in the field in New Mexico and received back crude in Longhorn, Texas for $22.75 plus $1.00, the value of the New Mexico oil would be $23.35. While this clearly can be the case when the sales are at market value, it is clearly not the case when they are below market value. For example, if one was presented with a contract providing for the sale of NM oil for $1.00 when the posted price for it was $18.00 and received back oil at Cushing for which it paid $1.50 when the Platt's value for West Texas Intermediate at Cushing was $19.50, it is hard to imagine that anyone would believe that $1.00 should be considered value.

In fact, in the section pertaining to all sales of oil under arm's-length contracts, the Handbook states:

> The MMS will not accept arm's-length gross proceeds or contract prices as royalty value if the lessee's sales contract does not reflect total consideration actually transferred, either directly or indirectly, from the buyer to the seller. Value for royalty purposes can never be less than the gross proceeds accruing to the lessee, and those gross proceeds must include any additional consideration identified in the contract.
>
> Total Consideration—"If the arm's-length contract does not set forth the total consideration passing directly or indirectly from the buyer to the lessee for the sale of oil, the lessee's gross proceeds may have to be adjusted to reflect the additional consideration (30 C.F.R. § 206.102(b)(1)(ii)). In some cases, the contract may not reveal special arrangements between the buyer and the lessee that may affect sales prices. For instance, in return for the lessee's reduced price for oil, the buyer may agree to reduce the cost of services it sells to the lessee, or under a separate agreement, the purchaser may reimburse the lessee for services that the lessee is obligated to perform at no cost to the lessor. In these situations, the value of the other consideration must be included as part of the gross proceeds accruing to the lessee.[30]

Obviously, the authors of the handbook were intending to point out the easiest example, without going into all the possibilities. It was not necessary to do so, because the

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[29] MMS, Royalty Management Program, Oil and Gas Payor Handbook, Vol. III, § 3.3 (1993).
[30] MMS, Royalty Management Program, *Oil and Gas Payor Handbook*, Vol. III, § 3.1 (1993).

text made it clear that the arm's-length rule would apply, which includes caveats 1. and 2. quoted above.

Transportation Buy-Sells and Exchanges

Another type of exchange agreement involves the transportation of the oil. In this type of agreement a producer usually wishes to transport oil through a proprietary pipeline owned by another person. The owner of such a line may only ship its own product, so it will purchase oil for the purpose of transportation. In that way it holds the title to the oil while it is in the pipeline. Such an agreement is not a sale as the producer expects to get back like quality oil at the downstream end of the pipeline. The only thing the exchange agreement defines is the transportation cost. While the stated prices in this type of agreement are irrelevant, the transportation differential does help to determine the value of the oil at the lease – it forms the cost basis of the transportation deduction for the pipeline segment covered for the non-owner shipper.[31]

MMS in 1996, after it learned that consideration in excess of posted prices was commonly being received, especially by major oil companies, clarified its guidance concerning auditing crude oil. In the guidance paper sent to MMS and State and Tribal auditors on June 24, 1996, MMS gave the following instruction:

> Crude oil produced from Federal leases is frequently disposed of under exchange agreements (e.g., buy/sell agreements) in which the lessee exchanges oil at one location for oil at another location. Title to the crude oil may transfer at the initial exchange point and a price may be specified in the agreement. However, when the agreement is conditioned upon the lessee's purchase of crude oil at a subsequent exchange point, the value specified in the exchange agreement does not necessarily reflect the total consideration received for the crude oil. Value at the initial exchange point must be determined based on the total consideration received for the crude oil, including any premiums received for the resale of the crude oil at the subsequent exchange point, less any allowable costs or location differentials specified in the exchange agreement.[32]

While this made a major difference in the practical application of the regulations for auditors (who had not been looking for premiums above posted prices as a matter of convenience, as explained above), it is completely consistent with the meaning of all the documents that preceded it. Value must be determined, at the minimum, by gross proceeds for all contracts. Gross proceeds is the total consideration accruing to the lessee, including any additional consideration received because of the ability to purchase non-lease oil (or any other thing) at less than market value. If the price stated in the agreement at the first exchange point is the true market value, then it may be used, otherwise MMS will look either to the total consideration accruing to the lessee (or if that cannot be calculated, it will

[31] *See e.g.* ARCO Oil and Gas Co. 109 IBLA 34 (1989)

[32] MMS, Royalty Management Program, General Guidance for Auditing Crude Oil at 2 (June 21, 1996).

apply the benchmarks). This was the position in *Cities*, in the 1988 regulation and in the valuation letters that apply it.

The other major Department of Interior group to consider exchanges was the Interagency Task Force. The Interagency Task Force applied the finding in *Cities* in determining how to view exchange agreements involving California crude oil. They concluded that "straight exchanges are not arm's-length sales" and that buy/sell transfers should not be considered arm's-length sales unless the oil company can establish that there are opposing economic interests in each buy/sell contract and that they really are outright sales."[33] In the terms used by the report straight exchanges involve the exchange of oil for locational advantages and does not reference a price. Buy/Sell contracts include stated consideration on both sides of the transfer. "However, the prices may bit represent reasonable value because any price may be used as long as the difference properly reflects the *relative* value of the crude oils being traded."[34]

Calculation of Value with Buy-Sell Exchanges

To calculate value when the lessee has sold its oil by the use of a buy-sell exchange, the lessee must calculate the total consideration received under each arm's-length contract for which it can calculate value. As the above discussion points out, for many buy-sell or exchange agreements value cannot be calculated. This is particularly a problem in California, as the Interagency Task Force pointed out in its report.[35] As MMS noted in the preamble to the final oil rule:

> However, in some circumstances the additional consideration may not be easily calculable. Thus, even if the parties are not affiliated and the contract is "arm's-length," MMS may require in paragraph (b)(1)(ii) that the oil production be valued in accordance with paragraph (c), the standards used to value oil disposed of under non-arm's- length contracts. Under these standards, the lessee's gross proceeds still may determine value, but the lessee will be required to demonstrate comparability to other arm's-length contracts.[36]

However for certain buy-sell agreements it is possible to calculate the total consideration received from the purchaser. As MMS explained in the preamble to the final rule:

> It is MMS's intent that the definition [of gross proceeds] be expansive to include all consideration flowing from the buyer to the seller for the oil, whether that consideration is in the form of money or any other form of value.

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[33] *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California* (May 16, 1996) at i. (Interagency Report)

[34] Id at 6. n 2.

[35] See text at n.33 *supra*.

[36] 53 FR at 1198.

> Lessees cannot avoid their royalty obligations by keeping a part of their agreement outside the four corners of the contract. Moreover, as noted earlier, many commenters stated that the "total consideration" concept properly belonged as part of gross proceeds, not in the definition of arm's-length contract. Therefore, MMS purposefully has drafted the gross proceeds definition to be expansive and thus include all types of consideration flowing from the buyer to the seller. Toward that end, MMS has replaced the word "paid" used in the first draft final rule with the term "accruing." There may be certain types of consideration which are not actually paid by the buyer to the seller, but from which the seller benefits. The term "accruing" ensures that all such consideration is considered gross proceeds.[37]

MMS went on to note in discussing contracts with additional consideration considered in § 206.102(b)(1)(ii):

> MMS recognizes, however, that there must be exceptions to the general rule that the lessee's arm's-length contract price should be accepted without question as the value for royalty purposes. One such situation is where the contract does not reflect all of the consideration flowing either directly or indirectly from the buyer to the seller. As an example, in return for Seller's reduced price for oil production from a Federal lease, Buyer may agree to reduce the price of gas it sells to the Seller from a non-Federal lease. This agreement is not reflected in the oil sales contract. In the event that MMS becomes aware of consideration that exists outside the four corners of the contract, MMS could accept the lessee's gross proceeds as value, adjusted to reflect the additional consideration. .... Thus, despite several industry comments suggesting that this section be deleted, MMS is retaining it in the final rules.[38]

While the adjustment for the additional consideration is not always transparent, there are many cases in which it can easily be accomplished. If the lessee sells oil at, say, Ship Shoal 274, for $16.00, and receives back the same number of shares of Microsoft stock for $1.50 less than the current price they are traded on the NASDAQ exchange, it is clear that the lessee has received $16.00 plus the $1.50 discount on the stock.

If the lessee receives a widely traded commodity, the same analysis holds true. For example, a lessee may exchange lease crude for West Texas Intermediate (WTI) at Cushing. WTI at Cushing is the principal exchange crude in the United States; it is the reference against which all other crude oils are traded. Importantly for it use in exchanges, and for the ability to use contracts that trade against it to value the base crude, it is widely traded in both cash and futures markets and its value is easily and contemporaneously ascertainable. Both the New York Mercantile Exchange (NYMEX) and **Platt's Oilgram**

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[37] 53 FR at 1194-1195.

[38] 53 FR at 1198.

make known contemporaneous prices. The NYMEX prices are "futures" prices and the Platt's prices are for delivery in the next month.

Another way to calculate the value of the crude oil received in the exchange may be to look to the actual resale by the lessee.[39] If a lessee sells its Ship Shoal 274 for $16.00 and receives back the same amount of WTI at Cushing for $17.00 and sells the WTI the next day for $18.50, the total received for the Ship Shoal oil is $16.00 plus $18.50 minus $17.00—or a total of $17.50. (*Sometimes the calculation is performed starting with the ultimate disposition ($18.50) and subtracting the difference in values between the oil sold and the oil received ($17.00-$16.00) or $18.50-$1.00=$17.50. These are mathematically equivalent formulas.)*

In any case, the issue is whether a reasonable value can be found for the crude oil received by the lessee in exchange for the crude oil. It is possible to use the actual resale price. This method has the advantage of being the actual monetary amount received by the lessee. It has the disadvantages that there are relatively few cash sales of oil at the second exchange point and that the lessee may do many things with the oil other than immediately selling it. The lessee may hold the oil for a period before selling. It may have sold it short, before receiving it or performed any number of more complex financial transactions before disposing of it. The more complex the transactions the more likely there is some consideration received that was not for the lease oil.

Using a known market price has the advantages of being easy to ascertain, not being subject to the peculiarities of the lessee's financial transactions and being an accurate reflection of the market value of the crude. It has the disadvantage that the lessee may have chosen to market in another way that does not match the market norm. While MMS has not put out definitive guidance on how to value the oil, the current payor handbook requires that value at the initial exchange point be "based on the total consideration ultimately received for the oil (including any premiums received for sales before, at or beyond the subsequent exchange point), based on whether the sale is arm's-length or non-arm's-length, and never less than the lessee's gross proceeds."[40] This allows considerable discretion in which method to use. It probably makes little difference how one values the non-lease oil received in exchange because unless the lessee has very unusual trading practices, the actual amounts received for oil should tend to be equal to the market value over time.

Application of the First Benchmark

Under the first benchmark, a lessee must value any production not sold pursuant to an arm's-length contract by using the volume-weighted average of the prices used in all of its (including its affiliate's or agent's) arm's-length sales (whether under a posted price or an oil sales contract), "sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area)". In addition, those prices

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[39] This method has been used in some MMS orders. *See, e.g.*, Russo, Lakewood Compliance Division, Order to Marathon Oil Co. (December 17, 1998).

[40] MMS, Royalty Management Program, *Oil and Gas Payor Handbook*, Vol. III, § 3.3 (1998).

must be comparable to other sales in the field or from the area. The rules define all the above-mentioned terms.

According to the definitions in the valuation regulations, a "lessee" includes the lessee of record (the person to whom the United States issued a lease), and the agent "who has been assigned an obligation to make royalty or other payments required by the lease." 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."[41] In addition, for the purposes of applying the benchmarks the term lessee includes the lessee's designated purchasing agent.

In the preamble to the final rule promulgated in January 1988, MMS explained why the definition of lessee included the purchasing agent (and what that term was intended to include). MMS added the concept in the final rule in response to a comment by an industry commenter. The commenter noted that strictly speaking many lessee's (in the traditional meaning) did not post prices, but rather that prices were "posted by a purchasing, marketing, or transporting entity, some of which may have producing lessee affiliates. 'However, taken literally, there will not be a lessee's posted price.'" Therefore, the term lessee, in the phrase "lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales" captures both arm's-length sales by the affiliate that is the owner of the lease and the sales and arm's-length sales and purchases by the "purchasing, marketing or transporting entity" affiliate.

To calculate the first benchmark value, a lessee must use the volume-weighted average of all its arm's-length purchases and sales. It should not use sales that would not be acceptable for value under the arm's-length valuation rule at 30 C.F.R. § 206.102(b). In responding to a comment on the application of the benchmarks, MMS noted:

> The MMS believes that, in the vast majority of cases, gross proceeds constitute market value. In those cases where this is not true, MMS will establish an appropriate value for royalty purposes. "Arm's-length" sales will not be accepted without question. The MMS will obtain needed information to ascertain that they are truly arm's-length as defined in the regulations.[42]

One of the biggest concerns regarded the lack of an adequate definition of the terms 'significant quantities.' "One State commenter stated that the term 'significant quantities' is vague and undefined. An industry commenter recommended that the term 'significant quantities' be deleted because (1) posted prices in an open marketplace 'are for no other purpose than determining market value', and (2) the lessee has no way of knowing the quantity of volumes purchased by other purchasers in the area."[43]

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[41] *See* 30 C.F.R. § 206.101 (1989). *See also* the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), which used a similar definition for lessee, until it was amended in 1996 by the Federal Oil and Gas Royalty Simplification Act (RSFA), 30 U.S.C. 1702.

[42] 53 FR 1184, 1201 (January 15, 1988).

[43] *Id.*

MMS responded that it would retain the concept and by noting that "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."[44]

Summary

MMS rules value crude oil based on the reality of the transactions engaged in in the market. When the transactions are exchanges and buy-sell contracts, both the gross proceeds rule and the first benchmark (that uses the lessees arm's-length contracts) require that the lessee report the total consideration received for the lease oil. That consideration is equal to the stated price of the lease oil, plus any additional consideration received from the ability to purchase another product for less than its market value. The additional consideration is the value of the product received, less its cost in the buy-sell or exchange transaction. For the oil that is actually sold in this way, the arm's-length gross proceeds rule applies. For oil transferred at less than arm's-length, the lessee must use the total consideration for the arm's-length buy sell and exchange transactions as part of the weighted average in the first benchmark.

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[44] Id. at 1202.