OIRA Meeting

March 12, 2020

MARCH 12, 2020 OIRA MEETING

OUTLINE OF TOPICS AND ISSUES

Valuation Topics (mostly Obama Rule: Natural Gas Valuation, Allowances, Default)

1. Significant Regulation and Valuation Changes
2. POP/POI and 153(c) Rulings
3. Index Valuation (Highest Bidweek Pricing)
4. Transportation vs. Gathering
5. Hard (Max) Allowance Caps
6. Default Rule

Marketable Condition Rule ("Revolution through Interpretation")

7. "No Market before Plant Tailgate"
8. No Limit on "Area"
9. Making Gas Marketable More Than Once

Non-Arm's-Length Sales

10. Affiliation Rule is Unworkable

Process Problems

11. Careless Audits and Orders
12. Unresolved Audits
13. Fix Confusion over 33-Month Clock

Civil Penalties Rule

14. Potential Heavy Penalties for Harmless Conduct

MARCH 12, 2020 OIRA MEETING

BRIEF SUMMARY OF TOPICS AND ISSUES

Valuation Topics (mostly Obama Rule: Natural Gas Valuation, Allowances, Default)

1. **Significant Regulation and Valuation Changes:** Obama's 2016 Valuation Rule imposed drastic, unnecessary regulation and royalty valuation changes that burden and disincentivize production on federal lands. *[Slides provide charts of oil and natural gas regulation changes.]*

2. **POP/POI and 153(c) Rulings:** Federal courts have blocked prior attempts at valuing unprocessed gas as processed gas. *See, e.g., Fina Oil and Chem. Co. v. Norton*, 332 F.3d 672, 678 (D.C. Cir. 2003); *Continental Resources, Inc. v. Gould*, No. 14-65, 2019 WL 1440111 (D.D.C. March 30, 2019). Under the Obama Rule, ONRR again seeks higher royalty value from producers who sell unprocessed gas under POP or POI contracts by determining value for residue gas and plant products. *[Slides illustrate Obama Rule and Continental decision.]* These regulations impose a heavy burden on energy development on federal lands and especially harm small independent producers. *[Exhibit: HL Brown Letter.]* Recommendation: Calculate royalty value for unprocessed gas sold under POP/POI contract based on (i) volume of product removed or sold (unprocessed gas) and (ii) fair-market price received (unprocessed gas pricing).

3. **Index Valuation (Highest Bidweek Pricing):** ONRR's index valuation for natural gas under the Obama Rule, 30 C.F.R. §§ 1206.141(c), 1206.142(d), is inconsistent with how producers sell their gas. ONRR's index valuation procedure requires producers determine the highest bidweek index price they could theoretically receive from any accessible system, without consideration for capacity constraints. We are unaware of any software package available that allows a payor to say with certainty they have followed all potential paths and determined the appropriate bidweek price. We are also unaware of any situation where a producer receives the highest reported bidweek price. *[Slide illustrates Obama Rule and negative Waha index.]* Recommendation: We recommend ONRR use a published index for the point a producer's oil or gas did reach or an average (if there are multiple indices).

4. **Transportation vs. Gathering:** Despite overwhelming precedent to the contrary, ONRR is attempting to disallow all costs of transportation upstream of the tailgate of a processing plant. *[Slide will illustrate.]* Recommendation: Create clear definitions. Gathering is the movement of production to the first meter measuring production from the well. If oil or gas is moved off-lease, transportation begins at the outlet flange of that first meter.

5. **Hard (Max) Allowance Caps:** The Obama Rule placed fixed caps on Transportation (50%) and Processing (66 2/3%) Allowances, whereas the prior rule allowed a payor to request an exception to exceed the allowance limits. ONRR noted it had not received very many requests to exceed the allowance limits and concluded the limitations should be a hard cap. This view is blind to the fact that prices fluctuate based on supply and demand, while transportation and processing fees typically do not. *[Slide will illustrate.]* Recommendation: Re-instate the former procedure.

6. **Default Rule:** The Obama Rule has expanded the scenarios under which ONRR can, during audit, second-guess a payor's arm's-length prices used to calculate royalty. The Obama Rule is free of any limiting principles on ONRR's power to second-guess. *[Slide will illustrate.]* Recommendation: Repeal the default rule.

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Marketable Condition Rule ("Revolution through Interpretation")

7. **"No Market before Plant Tailgate":** The definition of "marketable condition" has not changed since 1988, but ONRR's interpretation has evolved significantly. Where certain production has always been "marketable" and sold near the wellsite, under the Obama Rule that production is no longer "marketable" when sold. ONRR treats the tailgate of a processing plant as the earliest point of marketability – for all oil and gas, no matter the sales contract. *[Slide illustrates unchanged definition of "marketable condition," coupled with recognition of unprocessed gas producers' lack of control over production beyond sales point, as contrasted with ONRR's newfound interpretation under Obama Rule.]* These regulations impose a heavy burden on energy development on federal lands and especially harm small independent producers. *[Prior Exhibit: HL Brown Letter.]* Recommendation: Treat typical, fair-market sales contracts, including POP and POI contracts, as true indicators of marketability.

8. **No Limit on "Area":** According to ONRR, first market for Rockies gas can be the "end-use" market on either coast. *[Slide will illustrate.]* Recommendation: Define "area" to mean other fields in the same county.

9. **Making Gas Marketable More Than Once:** Under the Obama Rule, ONRR treats a "boosting" compressor at the outlet of a processing plant uniquely different from any other plant or field compressor, without explanation. ONRR seeks not only to disallow any deduction of "boosting" compression costs, but also shield "boosting" compressors from the marketable condition rule. This procedure contradicts a still-binding 2003 Assistant Secretary Valuation Determination. *[Slide illustrates Obama Rule and Valuation Determination.]* Recommendation: Issue statement to ONRR that clarifies the marketable condition rule, as applied to compression, that reaffirms (i) a lessee is required to place gas into a marketable pressure at no cost to the government only one time before selling the gas; and (ii) a lessee may choose "where—and in how many phases or steps" to place the gas in marketable condition. *[Exhibit: Sample Memorandum.]*

Non-Arm's-Length Sales

10. **Affiliation Rule is Unworkable:** ONRR has been unable to administer its complicated rule on how to tell whether a transaction is not at arm's-length. The rule looks to see whether the parties are "affiliated," attempting to analyze degrees of common ownership or control. ONRR lacks the experience and often the data to apply the multi-part test. *[Slide will illustrate.]* Recommendation: Replace with a simpler test as to whether lessee has financial incentive to low-ball price to the government's detriment.

Process Problems

11. **Careless Audits and Orders**. ONRR auditors frequently fail to follow government auditing standards for documenting claims. They wait until the statute of limitations has almost run, issue an undocumented claim, and force the lessee to disprove the claim. *[Slides illustrate published court decision involving Devon Energy and more recent examples.]* Recommendation: Auditors need better training and Departmental oversight, and ONRR Director should enforce proper auditing standards by withdrawing vague, incomplete, and other improperly issued Orders.

12. **Unresolved Audits**. ONRR carelessly spends taxpayer dollars on unresolved audits going back to (at least) 2002 production. ONRR has statutory authority to settle stale cases. It prefers to wear companies down by not settling. When it loses money because the claims are time-barred, the agency feels no consequences. *[Slides illustrate published court decisions involving Devon Energy and Continental Resources.]* Recommendation: Require ONRR provide a list of all pending claims for production prior to 2015 and explain reasoning for delay in resolution and/or why ONRR has not utilized Department's authority to "expedite collections relating to disputed obligations" under 30 U.S.C. § 1724(i). *[Exhibit: Sample Memorandum.]*

13. **Fix Confusion over 33-Month Clock**. In *Murphy Exploration & Prod. Co. v. U.S. Dep't of Interior*, 252 F.3d 473 (D.C. Cir. 2001), the D.C. Circuit ruled the 33-month clock runs from when the agency issues a demand for royalties. The agency still follows a regulation that doesn't start the clock for several weeks until a notice of appeal is received. *[Slide will illustrate.]* Recommendation: Amend the regulation to follow *Murphy*.

Civil Penalties Rule

14. **Potential Heavy Penalties for Harmless Conduct:** We see problems with ONRR's definition of "maintaining" inaccurate information, especially given the large penalties that can accrue. Under the Obama Rule, ONRR made a clerical error equivalent to a criminal act. It seems the rule was designed to allow ONRR unlimited authority to determine a reporting violation that has no royalty impact as a knowing and willful attempt to defraud the government. While ONRR may not be using the authority in this way and claims it won't, there doesn't appear to be a preclusion on it doing so. Recommendation: Repeal provision on maintenance.

Significant Regulation and Valuation Changes

*2016 Royalty Valuation Re-Reporting Rules (81 Fed. Reg. 43,338) – Most Impactful Highlighted **and Bolded***		
	Section(s)	**Re-Reporting Rule and Purpose**
Oil Re-Reporting Rules:		
1	**30 CFR §§ 1206.20, 1206.110**	***Rescinds Subsea Transportation.*** **"In this final rule, any movement of bulk production from the wellhead to a platform offshore is gathering and not transportation. ONRR changed the definition of the term 'gathering' and added paragraph (a)(1)(ii) in §§ 1206.110 and 1206.152 to rescind the May 20, 1999[] "Guidance for Determining Transportation Allowances for Production from Leases in Water Depth Greater Than 200 Meters." (Deep Water Policy). The Deep Water Policy allowed lessees to deduct certain costs associated with moving bulk production from the seafloor to the first platform." 81 Fed. Reg. at 43,340 (L); *see also* 81 Fed. Reg. at 43,343 (M).**
2	30 CFR § 1206.110	*Fifty-Percent Transportation Allowance Cap.* "In this final rule, we eliminated the regulation allowing us to approve transportation allowances in excess of 50 percent of the value of a lessee's oil production. Under this final rule, any prior approvals terminate on the date when this rule becomes final." 81 Fed. Reg. at 43,343 (M).
3	30 CFR §§ 1206.110, 1206.113, 1206.115	*Eliminating Transportation Factors.* "Previously, ONRR allowed lessees to net transportation from their gross proceeds when the lessees' arm's-length contract reduced the price of the oil by a transportation factor. In this final rule, we eliminated this provision and, instead, require lessees to report such costs as a separate entry on Form ONRR-2014." 81 Fed. Reg. at 43,344 (L); *see also* 83 Fed. Reg. at 43,345 (L, R).
4	**30 CFR § 1206.112**	***Eliminated Non-Arm's-Length Pipeline Losses.*** **"In this final rule, under paragraph (c)(2)(ii), ONRR eliminated the provision that allows lessees to deduct the costs of pipeline losses, both actual and theoretical, under non-arm's-length transportation situations." 81 Fed. Reg. at 43,345 (L).**
5	**30 CFR § 1206.112**	***Reduced BBB Bond Rate.*** **"ONRR reduced the multiplier on any remaining undepreciated capital costs from 1.3 to 1.0 times the Standard & Poor's BBB bond rate. We moved this provision to § 1206.112(i)(3)." 81 Fed. Reg. at 43,345.**

Significant Regulation and Valuation Changes

2016 Royalty Valuation Re-Reporting Rules (81 Fed. Reg. 43,338) – Most Impactful Highlighted and Bolded		
	Section(s)	Re-Reporting Rule and Purpose
Gas Re-Reporting Rules		
6	30 CFR §§ 1206.141, 1206.151	*Removed Dual Accounting.* "Because we removed the dual accounting requirement under proposed § 1206.151, we deleted paragraph (a)(3), which referenced it. We re-numbered proposed paragraph (a)(4) as (a)(3) in this final rule." 81 Fed. Reg. at 43,346 (L); *see also* 81 Fed. Reg. at 43,351 (R).
7	**30 CFR §§ 1206.141, 1206.142**	***First Arm's-Length Sale.*** **"In this final rule, ONRR eliminated the non-arm's-length valuation benchmarks and requires lessees to value gas production based on how they sell their gas (*such as* using (1) the first arm's-length sale prices, (2) optional index prices, or (3) volume weighted average of the values established under this paragraph for each contract for the sale of gas produced from that lease). Under § 1206.141(b)(2), if you sell or transfer your Federal gas production to your affiliate, or some other person at less than arm's-length, and that person or their affiliate then sells the gas at arm's-length, you will base your royalty value on the other person's (or their affiliate's) gross proceeds under the first arm's-length contract." "Under § 1206.142(c)(2), if you sell or transfer your Federal residue gas and gas plant products to your affiliate, or some other person at less than arm's-length, and that person or its affiliate then sells the residue gas and gas plant products at arm's-length, royalty value will be the other person's (or its affiliate's) gross proceeds under the first arm's-length contract. "[T]wo exceptions apply: (1) Lessees may elect to use the index-pricing option under § 1206.141(c) of this section, or (2) we decide to value your gas under the default valuation provision in § 1206.144." 81 Fed. Reg. at 43,346 (L), 43,349 (L).**
8	30 CFR §§ 1206.141, 1206.142	*Index-Based Valuation Option.* "ONRR added a new paragraph (c) containing an index-price valuation method that a lessee may elect to use in lieu of valuing its gas under proposed paragraphs (b)(2) and (b)(3). ONRR based the method on publicly[]available index prices, less a specified deduction to account for processing and transportation costs. This valuation method also applies to certain "no contract" situations that we describe under paragraph (c). The index-based option provides a lessee with a valuation option that is simple, certain, and avoids the requirements to unbundle fees and 'trace' production. This is applicable when there are numerous non-arm's-length sales prior to an arm's-length sale. Under paragraph (c), the lessee may choose to value its gas only in an area that has an active index pricing point published in an ONRR-approved publication. The lessee may elect to value its gas under this paragraph, making that election binding on the lessee for two years. ONRR will post a list of approved publications at www.onrr.gov." 81 Fed. Reg. at 43,346 (M); *see also* 81 Fed. Reg. at 43,349 (M).

Significant Regulation and Valuation Changes

2016 Royalty Valuation Re-Reporting Rules (81 Fed. Reg. 43,338) – Most Impactful Highlighted and Bolded		
	Section(s)	Re-Reporting Rule and Purpose
9	30 CFR §§ 1206.141, 1206.142	*No-Sale Situations.* "Paragraph (d)(1) provides that, if you have no written contract or no sale of gas subject to this section, and there is an index pricing point for the gas, then you must value your gas under the index-pricing provisions of paragraph (c) of this section unless ONRR values your gas under § 1206.144. We intended this provision to address situations including, but not limited to, when (1) the lessee sells its gas to an affiliate, and the affiliate uses the gas in its facility; (2) the lessee sells its gas to an affiliate, the affiliate resells the gas to another affiliate of either the lessee or itself, and that affiliate uses the gas in its facility; (3) the lessee uses the gas as fuel for its other leases in the field or area; or (4) the lessee delivers gas to another person as payment for an overriding royalty interest that the other person holds." 81 Fed. Reg. at 43,348 (L); *see also* 81 Fed. Reg. at 43,350 (R).
10	**30 CFR § 1206.142**	***Percentage-of-Proceeds and Percentage-of-Index Contracts.* "Paragraph (a)(2) applies to situations where a lessee sells its gas before processing and must base their royalty payments on any constituent products, resulting from processing, such as residue gas, NGLs, sulfur, or carbon dioxide. This final rule requires lessees to value POP contracts, percentage-of-index contracts, and contracts with any variations of payment based on volumes or the value of those products as processed gas." 81 Fed. Reg. at 43,348 (M).**
11	30 CFR §§ 1206.20, 1206.142	*Valuation of Keepwhole Contracts.* "Paragraph (a)(3) states that the lessee must value gas processed under a 'keepwhole' contract as processed gas. Under § 1206.20, we define the term *'keepwhole contract'* as a processing agreement under which the processor compensates the lessee by delivering to the lessee a quantity of residue gas (after processing) that is equivalent to the quantity of gas the processor received (prior to processing), normally based on heat content, less gas used as plant fuel and gas that is unaccounted for and/or lost. The lessee does not receive NGLs under these contracts. We often find that lessees are confused about how to value, for royalty purposes, gas processed under such contracts and then sold. This provision clarifies that a lessee must value gas processed under a keepwhole contract as processed gas. That is, royalty is based on 100 percent of the value of residue gas, 100 percent of the value of gas plant products, plus the value of any condensate recovered downstream of the point of royalty settlement prior to processing, less applicable transportation and processing allowances." 81 Fed. Reg. at 43,348-49.
12	**30 CFR § 1206.152**	***Rescission of Subsea Transportation.* "ONRR added a new provision stating that you may not take a transportation allowance for the movement of gas produced on the OCS from the wellhead to the first platform. This addition, along with the changes to the definition of gathering, rescinds the Deep Water Policy. We addressed comments pertaining to this issue, which we detail in § 1206.110, in this Preamble." 81 Fed. Reg. at 43,352 (L).**

Significant Regulation and Valuation Changes

2016 Royalty Valuation Re-Reporting Rules (81 Fed. Reg. 43,338) – Most Impactful Highlighted and **Bolded**		
	Section(s)	**Re-Reporting Rule and Purpose**
13	30 CFR § 1206.152	*Fifty-Percent Transportation Allowance Cap.* "ONRR eliminated the regulation allowing us to approve transportation allowances in excess of 50 percent of the value of a lessee's gas production. Any prior approvals will terminate on the date when the rule becomes final. We addressed comments pertaining to these issues, which we detail in § 1206.110, in this Preamble." 81 Fed. Reg. at 43,352 (L).
14	30 CFR §§ 1206.152, 1206.153, 1206.155	*Eliminating Transportation Factors.* "Previously, ONRR allowed lessees to net transportation from their gross proceeds when the lessees' arm's-length contract reduced the price of the gas by a transportation factor. We eliminated this provision and, instead, require lessees to report such costs as a separate entry on Form ONRR-2014. We addressed comments pertaining to this issue, which we detail in § 1206.110, in this Preamble." 81 Fed. Reg. at 43,352 (L); *see also* 81 Fed. Reg. at 43,352 (M), 43,353 (L).
15	**30 CFR §§ 1206.153, 1206.154**	***Eliminated Pipeline Losses.*** **"We addressed comments pertaining to this issue, which we detail in § 1206.111, in this Preamble." 81 Fed. Reg. at 43,352 (M);** ***see also*** **81 Fed. Reg. at 43,352 (R).**
16	30 CFR § 1206.153	*Eliminated Boosting.* "Under paragraph (c)(8), we specify that the costs of boosting residue gas are not allowable costs of transportation." 81 Fed. Reg. at 43,352 (M).
17	**30 CFR § 1206.154**	***Reduced BBB Bond Rate.*** **"We reduced the multiplier on any remaining undepreciated capital costs from 1.3 to 1.0 times the Standard & Poor's BBB bond rate. We addressed comments pertaining to this issue, which we detail in § 1206.112, in this Preamble." 81 Fed. Reg. at 43,352 (R).**
18	30 CFR § 1206.154	*Eliminated Use of FERC or State-Regulatory-Agency Approved Tariffs.* "We removed the provisions allowing a lessee with a non-arm's-length contract to apply for an exception to use FERC or State-regulatory-agency approved tariffs as an exception from the requirements to calculate actual costs." 81 Fed. Reg. at 43,352 (R).
19	30 CFR § 1206.159	*Processing Allowance Cap.* "We eliminated the regulation allowing us to approve processing allowances in excess of 66 2/3 percent of the value of a lessee's gas production. Any prior approvals will terminate on the date when the rule becomes final. We addressed issues related to prior approval terminations, which we detail in § 1206.110, in this Preamble." 81 Fed. Reg. at 43,353 (L).
20	30 CFR § 1206.159	*Eliminated Extraordinary Processing Allowances.* "We eliminated the provision that allows a lessee to request an extraordinary processing cost allowance. We previously allowed lessees to deduct processing costs up to 99 percent of the value of the gas plant products extracted *and* up to 50 percent of the value of the residue gas. This final rule also terminates the two existing extraordinary processing cost allowance approvals. We addressed issues related to the prior approval terminations, which we detail in § 1206.110, in this Preamble" 81 Fed. Reg. at 43,353 (M).

POP/POI and 153(c) Rulings

2. Calculating Royalty Value for Processed Gas Sold Under an Arm's-Length or Non-Arm's-Length Contract (§ 1206.142)

Percentage-of-Proceeds (POP) contracts: Paragraph (a)(2) applies to situations where a lessee sells its gas before processing and must base their royalty payment on any constituent products, resulting from processing, such as residue gas, NGLs, sulfur, or carbon dioxide. This final rule requires lessees to value POP contracts, percentage-of-index contracts, and contracts with any variations of payment based on volumes or the value of those products as processed gas.

Public Comment: Commenters from industry, industry trade groups, and STRAC opposed this change. Industry commenters and STRAC focused their comments on the reporting burden and financial impact of this change. One commenter explained, "Because POP contracts have, since, November of 1991 been subject to the unprocessed gas valuation regulations, many companies do not have accounting systems set up to report anything other than a single product code 04 line." The commenters explain that this proposed change would impose significant accounting system costs and delays in reporting.

Contrary to the commenter's assertions, past regulations did place the responsibility on lessees who sell their gas at the wellhead under POP-type contracts to place the residue gas and gas plant products into marketable condition at no cost to the Federal government. Simply selling the gas at the wellhead does not mean that the gas is in marketable condition—one must look to the requirements of the main sales pipeline. The U.S. District Court for the Northern District of Oklahoma supported ONRR's position under the past regulations, finding that, "Whether gas is marketable depends on the requirements of the dominant end-users, and not those of intermediate processors" *Burlington Res. Oil & Gas Co. LP* v. *U.S. Dep't of the Interior*, No. 13–CV–0678–CVE–TLW, 2014 WL 3721210, at *11 (N.D. Okla. July 24, 2014).

POP/POI and 153(c) Rulings

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Dkt. 76 at 8 (Mar. 22, 2019 Hrg. Trans.). Instead, the Director's decision turned on the premise that Continental's sale of *unprocessed* gas to Hiland was not at arm's length. Whether or not that assessment was accurate, it has nothing to do with Section 153(c), which applies only if the *processed* gas at issue was "not sold pursuant to an arm's-length contract." 30 C.F.R. § 206.153(c).

based on a theory raised for the first time on judicial review. Nor is the Court convinced, at least on the present record, that the approach that the Director adopted is the best of a range of bad interpretative options. Although other provisions of the regulation might not fit perfectly, applying those provisions that address the non-arm's-length sale of *unprocessed* gas at least makes sense. Rather than sort through these other options in the first instance, however, the

Continental Resources, Inc. v. Gould, 374 F. Supp. 3d 28 (D.D.C. 2019) (holding ONRR Director royalty valuation of unprocessed gas sold under POP contract as processed gas was contrary to law, arbitrary, and capricious)

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March 11, 2020

Mr. Scott Cameron
Principal Deputy Assistant Secretary for Policy, Management, and Budget
United States Department of the Interior

Dear Mr. Cameron:

Our counsel has invited us to comment on Federal regulations relating to oil and gas royalties paid under Federal leases. We operate a small field in New Mexico, the gas from which is purchased under a "percent of index" contract. We are a small operator with no leverage and no other alternative source. For years we paid the standard 12-1/2% Federal royalty on proceeds we received from our purchasers. Our purchasers buy our gas unprocessed and pay us 80% of an index price for processed gas. New regulations under the Obama administration require us to pay royalty on 100% of this index price, but we do not receive that value for our gas. We no longer have title control over the gas once we sell it. We do not process the gas or receive value for processed gas or processed products. We receive money for our gas as unprocessed. We incur considerable costs to produce and transport this gas and we go out of business when we lose money.

Given the age of these wells, costs are increasing, production is declining, and the value of gas is low in the current marketplace, such that the only wells we produce that are making a profit are the few wells in the field that make a substantial amount of oil. We essentially have three categories of wells today we're paying royalties on. 1.) Wells that make only gas for which there is very little value in the market. 2.) Wells that make some gas and a little oil that are barely breaking even because of the oil. 3.) A few wells that make enough oil to cover expenses and overcome the royalty on 100% of the gas value, even though we only receive 80%. We are already needing to plug the wells in category 1, either plug or flare the gas in category 2, and then attempt to maintain the gas production on the wells in category 3. When this happens, we think our purchasers will likely want to renegotiate our price to a percentage lower than 80%, since we'll have even less leverage when we plug and/or flare the gas from the wells in the first two categories. In that instance, we could be faced with flaring gas even on the profitable oil wells. In all three scenarios, the point is reached where producing gas and paying royalties on monies we don't receive becomes impossible for a profit-making business.

It would seem to us that if the government wanted to act prudently to enhance the production of this resource, it would collect a fair royalty from us based on the gas we produce and sell and not ask us to pay royalties on pricing we do not receive. If ONRR wishes to receive royalty on the processors hold back, they should require the processors to pay on that volume, not the operators. Expecting us to pay royalty on processed gas also puts us in an impossible position of having to claim as deductions the costs our purchasers incur. Our buyers won't share their cost information with us. It is unfair to expect us to do what is, in fact, impossible. And we've been told there is no comparable system or processing plant for our area, so we can't use any of ONRR's published deductions. So, what little relief we might receive under the regulations is unavailable in reality. As such, we're paying what effectively amounts to a 20% royalty on the sales proceeds we actually receive out of sales prices that are inadequate to begin with. I would suggest if you're interested in keeping gas producers in business for the purpose of America maintaining energy independence, receiving a royalty of 12-1/2% on the 80% we actually receive is better than receiving a royalty of 12-1/2% on 100% of 0, which is where we'll be when we start plugging wells and/or flaring gas, because we can't afford to produce it and have it processed.

As I say, we're small producers, but small producers have taken the risks required to have discovered many of the oil and gas fields in the United States, a situation that exists to this day. I think the reality that 12-1/2% on 100% of 0 is 0 is a concept worth remembering as you consider policy affecting oil and gas producers' royalties on natural gas wells.

We will be anxiously hoping for relief from these provisions that we assume were unintended consequences of the current regulations.

Respectfully yours,

Kenneth L. Zoller, CPA
Financial Manager

Index Valuation (Highest Bidweek Pricing)

means that you have multiple index pricing points to which your gas can physically flow. Also, assume that the highest reported monthly bidweek price among the multiple index pricing points is the Tennessee Gas 500 Leg Price at the tailgate of the Yscloskey Plant. Finally, assume that you cannot flow your gas through the Tennessee Gas Pipeline (to the Yscloskey Plant) because all available capacity on that pipeline is under contract to other persons, and the pipeline has no capacity available to you for the production month—in other words, it is constrained. In this example, you would use the highest reported monthly bidweek price at the tailgate of the Yscloskey Plant as the value under this paragraph even though your gas did not flow to that index pricing point during that production month.

The third scenario is when there are multiple sequential pricing points on a pipeline through which you could transport your gas. In this scenario, you must base your value for royalty purposes on the first index pricing point after your gas enters that pipeline.

- Obama Rule has replaced the previous rule's "benchmarks" for non-arm's-length sales with an electable index option, which calls for payors to use "the highest reported monthly bidweek price for the index pricing points to which your gas could be transported for the production month, whether or not there are constraints for that production month." 30 CFR 1206.141(c)(1)(ii), 1206.142(d)(1)(ii) (emphasis added).

- We are unaware of any software package available to follow this procedure, and we are unaware of any situation where a producer receives the highest reported bidweek price. It would be more sensible for ONRR to use a published index for the point a producer's oil or gas did reach (or an average thereof if there are multiple indices).

- 2-year Election Problem: Beginning March 2019, the Waha Index has run negative off and on for a few months, while high prices through other indices were positive. If a producer had elected index valuation in March 2018, it would be required to pay royalty based on the highest price (positive) in addition to what it had to pay its purchaser(s) to take the gas (due to the negative Waha Index price).

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Transportation vs. Gathering - 1

- Federal oil and gas leases require that royalties are valued "at the lease." Even under the Obama rule, transportation means moving oil or gas "to a point of sale or delivery off the lease," 30 C.F.R. 1206.20 ("transportation allowance"), the historical definition.
- For example, a subsea well on a deepwater lease may be connected by flowlines 30-50 miles shoreward to a floating production platform. The technology is complex and expensive.
- The Obama rule disallows transportation allowances for that movement. Just in the last three years, this disallowance amounts to tens of millions of dollars in excess royalties. It disincentivizes deepwater investment.

Transportation vs. Gathering - 2

- The Obama rules and ONRR staff use a vaguely worded term "gathering."
- Gathering, 30 C.F.R. 1206.20 ("gathering"), means movement of oil or gas "to a central accumulation or treatment point on the lease" or if approved by Interior, off the lease.
- By definition, "gathering" is not "transportation." But after 100 years of royalty rules, Interior still cannot articulate why the lessee should not get a deduction once the oil or gas leaves the lease.
- Nor, 100 years in, can Interior explain what a "central accumulation point" or "treatment point" is. Most recently, ONRR has interpreted it to deny movement of offshore oil and gas all the way from the platform to the beach.

Hard (Max) Allowance Caps

- Historically, a lessee can deduct costs of transportation (for oil and gas) and processing (for gas) from proceeds from sale of production.
- If the value of the transportation of the oil or gas was more than 50 % of the value of the oil or gas itself, the lessee could not deduct the excess.
- Unless Interior approved deducting the excess. E.g., 30 C.F.R. 1206.156(c)(1) (2015).
- Interior approved if the excess cost was "reasonable, actual, and necessary." *Id.*
- Now, the excess may never be deducted. E.g., 30 C.F.R. 1206.110(d)(2).
- Why? E.g., "The 50-percent limitation is a sufficient transportation allowance." We have discretion not to give you any allowance at all. 81 Fed. Reg. 43343 (July 1, 2016).

Default Rule

- ONRR reserves the right to reject any arm's-length sale fir royalty value if ONRR finds the contract does not reflect "reasonable consideration." 30 C.F.R. § 1206.104.
- For example, if the lessee sells for a price 10 percent less that index prices or prices received by others.
- Or, if a company ONRR thinks is an "affiliate" and the affiliate does not provide documents ONRR requests.
- This rule returns royalty valuation to the pre-Reagan era when royalty value was whatever the Interior Department decided, long after the month of production, what a reasonable value was.
- Why the departure? "We have never tacitly accepted values received under arm's-length contracts." 81 Fed. Reg. 43341 (July 1, 2016). Not "tacitly," expressly:
- "There is ample evidence that arm's-length sales provide a consistent and accurate measure of all commodities for which we collect royalties." 81 Fed. Reg. 43354 (July 1, 2016).

"No Market before Plant Tailgate"

Marketable condition means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area for Federal oil and gas, and region for Federal and Indian coal.

One company stated that the current regulations recognize that the lessee no longer has title to or control over production after its POP buyer takes possession at the wellhead or plant inlet, highlighting that the lessee is not obligated to place residue gas and plant products in marketable condition. It believes that, by treating arm's-length POP contracts as sales of processed gas, ONRR improperly places the burden on the lessees to bear the costs to place

Contrary to the commenter's assertions, past regulations did place the responsibility on lessees who sell their gas at the wellhead under POP-type [illegible]tracts to place the residue gas and gas p[illegible] products into marketable conditi[illegible] no cost to the Federal government. Simply selling the gas at the wellhead does not mean that the gas is in marketable condition—one must look to the requirements of the main sales pipeline. The U.S. District Court for the Northern District of Oklahoma supported O[illegible]tion under the past regula[illegible] find[illegible]hat, "Whether gas is mar[illegible] depe[illegible] on the requireme[illegible] of [illegible] ant end-users, and not th[illegible] of in[illegible]ate processors' [illegible]es. *Oil & Gas Co. LP* v. *U.S.* [illegible] *the Interior*, No. 13–CV–0678–CVE–TLW, 2014 WL 3721210, at *11 (N.D. Okla. July 24, 2014).

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No Limit on "Area"

- The marketable condition rule, to this day, puts the burden on the lessee to pay for costs needed to sell production under "a sales contract typical for the field or area."
- Everyone still agrees that a "field" is a designation set by federal or state oil and gas conservation agencies (for purposes independent of royalty payments).
- "Area" used to mean other fields near the given field, because the given field did not have enough sales activity to permit a finding that a contract was "typical."
- Today, the word "reasonably refers to the contracts that are typical in the field or area into which the gas is actually sold, which may or may not be the field or area where the gas is produced." 81 Fed. Reg. 43342 (July 1, 2016).
- This means that gas produced in central Colorado now is held to quality specifications for gas sold in California, Chicago, or New York. True even if gas is initially sold at arm's-length to buyers in Colorado, who then market downstream.

Making Gas Marketable More Than Once

Boosting: Under paragraph (c)(8), we specify that the costs of boosting residue gas are not allowable costs of transportation.

ONRR Response: Current regulations and case law make clear that the cost incurred—including any fuel used—to boost gas (such as compress residue gas after processing) is not a deductible cost of processing or transportation (30 CFR 1202.151(b); *see also Devon Energy Corporation* v. *Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008), cert. denied, 130 S. Ct. 86 (2009), (finding that boosting is not deductible even if gas is in marketable condition before entering a gas processing plant)). Yet a number of members of industry continue to deduct costs incurred to boost residue gas as either a processing or a transportation allowance, and they argue that it is proper to do so. The inclusion of paragraph (c)(8) reinforces current regulations and case law and therefore we retained it in the final rule.

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Making Gas Marketable More Than Once

ONRR Response: Current regulations and case law make clear that the cost incurred—including any fuel used—to boost gas (such as compress residue gas after processing) [illegible] a deductible cost of proces[illegible]ion (30 CFR 1202.1[illegible] Energy Corp[illegible] Kempthor[illegible]51 F.3d 1030 [illegible]08), cert[illegible]ed, 130 S. C[illegible] 2009[illegible]ing th[illegible]oosting is n[illegible]uctible[illegible]n mark[illegible] conditi[illegible]tering a gas pr[illegible] plant[illegible]number of members[illegible]ue to deduct costs incurr[illegible]residue gas as either a processing or a transportation allowance, and they argue that it is proper to do so. The inclusion of paragraph (c)(8) reinforces current regulations and case law and therefore we retained it in the final rule.

Compression Necessary to Reach Marketable Condition:			
Marketable Condition	1,100 psi		
- Wellhead Pressure	2 psi		
= Necessary Compression	1,098 psi		
Lessee's Compression:			Deductible?
Rotary Screw Compressors	From 2 psi to 100 psi	98 psi	No
Reciprocating Compressors	From 100 psi to 800 psi	+ 700 psi	No
Plant Compression	From 800 psi to 1,100 psi	+ 300 psi	No
		= 1,098 psi	
MTG Booster	From 450 to 1,200 psi	750 psi	Yes

Note: "Plant Compression" was a plant compressor located at the outlet of the facility. MTG "Booster" was in the field.

Devon Energy Corp. v. Kempthorne, 551 F.3d 1030 (D.C. Cir. 2008) (including plant boosting pressure increase in marketable condition analysis, allowing deduction of compressors along transportation system); *see* October 2003 Valuation Determination issued by Assistant Secretary at 29-30.

Making Gas Marketable More Than Once

(8) *Other non-allowable costs.* Any cost you or your affiliate incur(s) for services that you are required to provide at no cost to the lessor, including, but not limited to, costs to place your gas, residue gas, or gas plant products into marketable condition disallowed under § 1206.146 and costs of boosting residue gas disallowed under § 1202.151(b).

(9) *Supplemental costs for compression, dehydration, and treatment of gas.* ONRR allows these costs only if such services are required for transportation and exceed the services necessary to place production into marketable condition required under § 1206.146.

Memorandum

TO: Assistant Secretary, Policy, Management, and Budget
Principal Deputy Assistant Secretary, Policy, Management, and Budget

FROM: Acting Deputy Secretary

DATE: March __, 2020

SUBJECT: Interpretation and Clarification of the Marketable Condition Rule Concerning Compression of Federal Natural Gas

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It is well-established that a federal gas lessee has the obligation to place production in marketable condition at no cost to the lessor. 30 C.F.R. §§ 1206.152(i) (unprocessed gas), 1206.153(i) (processed gas). Compression of natural gas has long been considered a component of placing the gas in marketable condition.

In a 2003 royalty valuation determination ("the *Devon* decision"),[1] the Assistant Secretary, Land and Minerals Management, determined that when a lessee must compress natural gas to reach marketable condition, there are two key limitations on the lessee's obligation. First, a lessee is required to place gas into a marketable pressure at no cost to the government only one time before selling the gas.[2] Second, a lessee may choose "where—and in how many phases or steps" to place the gas in marketable condition.[3] This memorandum reaffirms these two principles and clarifies how they apply to two questions.

1. The first question concerns so-called "boosting" costs. When natural gas is processed to remove liquefiable components such as ethane and propane, the pressure of the gas stream may drop as part of the processing. The drop may place the gas leaving the processing plant at a pressure below what is needed to enter a nearby pipeline. Frequently, there will be a compression unit at the tailgate of the processing plant, *i.e.*, upstream of the pipeline inlet, to "boost" the pressure back up to what is needed for the gas to enter the pipeline. In many cases, the pressure of the gas entering the pipeline can be the pressure needed to place the gas into marketable condition. Questions have arisen as to whether a federal lessee may ever deduct the cost of boosting the gas to pipeline pressure under the *Devon* decision.

Under the regulations, a "reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 C.F.R. part 1206." 30 C.F.R. § 1202.151(b). This regulation disallows deduction of boosting costs, unless the deduction is permitted as provided in 30 C.F.R. Part 1206.

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[1] Devon Energy Corp., Assistant Secretary's Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Power River Basin, Wyoming (Oct. 9, 2003), *aff'd by Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008).
[2] *Devon* decision at 30.
[3] *Devon* decision at 29.

Part 1206 includes not only the marketable condition rule, but also sections 1206.157(f)(9) and 1206.158(a). Section 1206.157(f)(9) allows a lessee to deduct "supplemental costs of compression" that "exceed the services necessary to place production into marketable condition."[4] Section 1206.158(a) allows a lessee to deduct "the reasonable actual costs of processing." If the lessee has already placed the gas into a marketable pressure once at no cost to the government, then it may deduct boosting costs permitted by Part 1206. The lessee may also elect to do the opposite. It may deduct certain costs of initially placing the production into a marketable pressure, then not deduct the costs of boosting for an equivalent amount of pressure needed to achieve marketable condition. This is what the *Devon* decision means when it says the lessee may choose "where—an in how many phases or steps" it meets its duty to add pressure required by the marketable condition rule.[5]

2. The second question concerns the treatment of compression costs when a lessee uses multiple compression stages to place the gas into a marketable pressure. If one of those compression stages adds more pressure than needed to reach marketable condition, then allowable costs of the extra pressure should be measured using the pressure added by that particular stage (the discharge pressure minus the inlet pressure). For example, if gas entered a compressor at 700 psig and exited at 900 psig, which was 50 psig higher than the 850 psig needed to reach marketable condition, then the lessee should be able to deduct 25% ((900-850)/(900-700)) of the costs of that particular stage.

The correct approach to determine what may be deducted has been explained by the Office of Natural Resource Revenues ("ONRR").[6] This memorandum approves this method as consistent with the principle of the *Devon* decision that gas need only to be placed into marketable condition once. Before adopting this position, however, ONRR had previously followed a different methodology. It treats the former methodology as a still-acceptable option for enforcement[7] and has issued orders based upon it. That methodology requires lessees to divide the allowable pressure added by a particular stage by the total discharge pressure from the compression system as a whole, allowing only a 5.5% ((900-850)/900) deduction in the example above. This approach requires the lessee to apply more compression than is needed to place natural gas into a marketable pressure once. It is inconsistent with the *Devon* decision and is disapproved.

ONRR is directed to review pending orders and cases and act, where necessary, to make its actions consistent with this memorandum.

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[4] "Compression" is "the process of raising the pressure of gas." 30 C.F.R. § 1206.151. Boosting is a form of compression.

[5] A footnote in Devon stating, "It may be argued [that] in some circumstances" the section 1202.151(b) boosting provision creates an exception to the general rule that lessees are not required to condition production at their own expense more than once would not apply to circumstances where "part 1206" allows a deduction. Such an argument would contradict the "except as provided in 30 C.F.R. part 1206" language in section 1202.151(b).

[6] https://www.onrr.gov/unbundling/pdf/How-to-calculate-a-Transportation-UCA.pdf at 4 ("Option #1"); https://www.onrr.gov/unbundling/pdf/How-to-calculate-a-Processing-UCA.pdf at 4 (Option #1)

[7] *See* https://www.onrr.gov/unbundling/pdf/How-to-calculate-a-Transportation-UCA.pdf at 4 ("Option #2"); https://www.onrr.gov/unbundling/pdf/How-to-calculate-a-Processing-UCA.pdf at 4 (Option #2).

Affiliation Rule is Unworkable - 1

- The royalty rules historically value transactions depending on whether the parties are affiliated.
- The definition of "affiliate" is 242 words long. 30 C.F.R. 1206.20 ("affiliate").
- It echoes concepts from the federal securities laws.
- It creates presumptions of control and non-control. Common ownership of voting securities or other forms of ownership.
- More than 50 percent, 10 through 50 percent, less than 10 percent.
- ONRR does not hire people who understand corporate control.

Affiliation Rule is Unworkable - 2

- The concept should be simple: does affiliation give the parties a financial incentive to low-ball the price or inflate the allowance for transportation or processing?
- If one company wholly-owns both the seller and the transporter, sure. An inflated transportation cost doesn't hurt the parent and reduces the royalty owed.
- Now assume the royalty rate is one-eighth. If the seller owns only 60% of the transporter, the incentive to cheat is gone. For every extra dollar charged in transportation, the seller gets only a 60-cent benefit.
- In other words, the seller saves twelve-and-one-half cents in royalties (one-eighth of the extra dollar), but gives up 40 cents to do so.
- In this case, the seller has all the incentive as in a fully arm's-length transaction to keep transportation costs down.

Careless Audits and Orders

By enacting the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, Congress "established certain prerequisites that ONRR must satisfy before ordering a lessee to revise prior period reports and payments." Jane Campbell & Sarah Dicharry, *ONRR's Tools for Compliance I: Data Mining, Compliance Reviews, Audits, and Orders*, 5 ROCKY MOUNTAIN MIN. L. INST. 3 (2018). One of those prerequisites is that ONRR must identify the reasons it believes a lessee owes additional payments on account of its royalty obligations. 30 U.S.C. § 1702(26). In this case, ONRR identified problems with volume and royalty reporting, and then it indicated that any outstanding transportation deductions issues had been resolved through the audit process. Therefore, transportation deductions could not have been a reason for ONRR's "demand" that Devon pay its royalty "obligations." The Court thus rejects Respondents' contention that the December 16, 2010 order is a valid demand. Because Respondents present no other argument on the issue and the Director's decisions were not issued until seven years after the 2002–2004 audit period, the Court agrees that ONRR's claims regarding the 2002–2004 audit period are time-barred. Accordingly, the ONRR Director's decision and the IBLA's deemed affirmance of

21. Devon is correct that the 2005–2007 ONRR order was not the picture of clarity regarding the marketable condition analysis. The ONRR erroneously believed that Williams gathered Devon's gas before the Unit boundary even though the gas had been moved to "a central accumulation and/or treatment point on the lease" at the Unit's royalty measurement points. (*See* 2002–2004 AR at 847). Yet by making such an assertion, the ONRR necessarily suggested marketable condition problems with Devon's gas.

Devon Energy Prod. Co., L.P., Cons. Case No. 2:16-cv-161 (D. Wyo. Sept. 11, 2019) (vacating one ONRR Director decision (2002-2004 production) for failure of ONRR to issue a proper order and remanding another decision (2005-2007 production) for failure of ONRR to review a lessee's marketable condition evidence and analysis).

Careless Audits and Orders

- H.L. Brown Operating, LLC operates a small field in New Mexico's Permian Basin.
- Working through its delegate, the New Mexico Taxation Revenue Department, ONRR issued an Order without reviewing data and marketable condition analyses H.L. Brown had provided to auditors over 6 months prior.
- Auditors admit they did not complete their review of these data or analyses before issuing the Order but refused to withdraw the Order, maintaining that H.L. Brown must still bond or pay the full Order amount to initiate any appeal.

Data and Analyses referenced in Order:

Mr. Kenneth L. Zoller
H.L. Brown Operating, LLC.

Enclosure(s)
Enclosures 1 - Explanation of Order
Enclosures 2 - Audit Issue Letter
Enclosures 3 - HL Brown Audit Issue Letter Response dated September 29, 2016
Enclosures 4 - HL Brown Audit Issue Letter Response dated January 13, 2017
Enclosures 5 - State of NM Supplemental Response Review dated March 30, 2017
Enclosures 6 - HL Brown Audit Issue Letter Final Response dated October 31, 2017
Enclosures 7 - Issue 1 Additional Royalties Due
Enclosures 8 - Issue 2 Additional Royalties Due
Enclosures 9 - Appeals Procedures
Enclosures 10 - Surety Instructions

Data and Analyses <u>Omitted</u>:

Ms. Julia Maddux
January 20, 2017
Page 2

data disc containing HL Brown's suggested revisions to these schedules, as well as our depreciation analysis, for all test months during the Audit Period.

June 2, 2017

CONFIDENTIAL PURSUANT TO
18 U.S.C. § 1905 AND 5 U.S.C. § 552

VIA E-MAIL AND FEDERAL EXPRESS

Julia Maddux
Federal Royalty Audit Supervisor

June 6, 2017

CONFIDENTIAL PURSUANT TO
18 U.S.C. § 1905 AND 5 U.S.C. § 552

VIA E-MAIL AND FEDERAL EXPRESS

Julia Maddux
Federal Royalty Audit Supervisor

Julia Maddux
Manuel Lozano
December 8, 2017
Page 2

revisions to the State's spreadsheets for all test months during the Audit Period. As these spreadsheets demonstrate, HL Brown is likely entitled to a refund for royalties paid during the Audit Period.

Careless Audits and Orders

- DCOR, LLC owns and operates federal offshore leases located off the Southern California coastline and transports its oil and gas production from OCS platforms to facilities on the California coast. Since inception in the 1970s, every operator of these leases has been permitted to deduct transportation costs from royalty payments.
- After ~4 years auditing, ONRR issued two Orders for 2007 – 2010 production that directly contradict one another:
  - In the First Order, auditors attempted (erroneously) to calculate appropriate transportation allowances for the leases – allowing certain costs, disallowing other costs. In haste, the auditors applied their calculations from one system to all other unrelated systems and applied cost data only from one year to all other years.
  - In the Second Order, ONRR auditors categorically denied all transportation allowances for the leases.

in November 2016 that we had just turned the corner on the audit and was moving forward. However, we simply ran out of time. When Greg noted that DCOR was not given any opportunity to respond, I did inform him that we sent the preliminary

Office of Natural Resources Revenue
Meeting/Conversation Record

Case No. 14-00095 PAD No. 39015083	Audit	Date: 02/28/2017
Conversation With: Name: Greg Summers Phone: 469-621-8046 *Additional parties on conference call were not identified.* Email	Organization: DCOR, LLC	Analyst/Auditor: Karen Torsney
RE: Order 02-24-2017		

Unresolved Audits

Although the Director did not overreach by considering Devon's arguments, the Court finds that, at least to some extent, the procedural sequence leading to his decisions was deficient. Specifically, for the 2002–2004 audit, the ONRR never issued a proper demand.

Under 30 U.S.C. § 1724, the ONRR must "demand" a royalty payment "which arises from, or relates to an obligation . . . within seven years from the date on which the obligation becomes due . . . ." Failure to provide lessees with such demands (or to initiate a judicial proceeding) bars the agency from taking "any other or further action regarding that obligation" or pursuing "any other equitable or legal remedy . . . with respect to an action on or an enforcement of said obligation." *Id.*

ORDERED that the Order (ONRR-11-0007-O&G) of Director Gregory G. Gould of the Office of Natural Resources Revenue for the time period of 2002–2004 is hereby **VACATED** to the extent it seeks additional royalties from Devon on account of improper transportation deductions;

IT IS FURTHER ORDERED that the Order (ONRR-12-0083-O&G) of Director Gregory G. Gould of the Office of Natural Resources Revenue for the time period of 2005–2007 is hereby **VACATED** to the extent it seeks additional royalties from Devon on account of improper transportation deductions, and that this matter is **REMANDED** so that the ONRR can consider Devon's marketable condition and unbundling analysis to determine the propriety of Devon's claimed transportation deductions for that time period;

Devon Energy Prod. Co., L.P., Cons. Case No. 2:16-cv-161 (D. Wyo. Sept. 11, 2019) (vacating one ONRR Director decision (2002-2004 production) for failure of ONRR to issue a proper order and remanding another decision (2005-2007 production) for failure of ONRR to review a lessee's marketable condition evidence and analysis).

Unresolved Audits

Plaintiff Continental Resources, Inc. ("Continental") extracts natural gas from federally leased land and pays royalties to the federal government based on the value of the gas that it sells. From 2003 to 2006, Continental repprted and paid royalties to the Department of Interior's Minerals Management Service ("MMS")—a predecessor to what is now the Office of Natural Resources Revenue ("ONRR")—for leases in Washakie County, Wyoming based on Continental's assessment that it sold its unprocessed gas to an unaffiliated entity pursuant to an arm's-length agreement. Following an audit, MMS disagreed and found that both Continental

CONCLUSION

Defendant's motion for summary judgment, Dkt. 61, and motion for leave to file supplemental briefing, Dkt. 72, are hereby **DENIED**, and Plaintiff's motion for summary judgment, Dkt. 56, is hereby **GRANTED** for the reasons set forth above. It is, accordingly, **ORDERED** that the matter be remanded to the Board of Land Appeals for further proceedings consistent with this opinion.

Continental Resources, Inc. v. Gould, 374 F. Supp. 3d 28 (D.D.C. 2019) (holding ONRR Director royalty valuation of unprocessed gas sold under POP contract as processed gas was contrary to law, arbitrary, and capricious)

Memo

TO: Director,
Office of Natural Resources Revenue

FROM: Principal Deputy Assistant Secretary, Policy, Management, and Budget

DATE: March _______, 2020

SUBJECT: Resolution of Aging ONRR Claims

There are pending before the Department and in the courts claims by the Office of Natural Resource Revenues against federal lessees for underpaid royalties. Some claims appear to be for production months going back many years. On September 11, 2019, a federal judge held that ONRR's claims for certain royalties for the period 2002-2004 were time-barred. *Devon Energy Production Co., LLP v. Gould*, No. 16-CV-000161-ABJ (D. Wyo.).

The Department is tasked by law to "ensure the prompt and proper collection" of royalties. 30 U.S.C. §1701(b)(3). It is inconsistent with that mandate to have unresolved claims dating back 17 years or more. By [date], please provide a list of all pending claims for production prior to 2015, explaining the reason for the delay in resolution and why ONRR has not used the Department's authority to "expedite collections relating to disputed obligations" under 30 U.S.C. §1724(i).

Fix Confusion over 33-Month Clock

- By statute, Interior has 33 months to issue a final decision in any royalty proceeding. 30 U.S.C. § 1724(h)(1). After 33 months, the order is deemed final.
- The 33-month period begins when ONRR issues an order. *Murphy Expl. & Prod. Co. v. Dep't of the Interior*, 252 F.3d 473, 480-82 (D.C. Cir. 2001).
- Interior still follows a regulation that the period starts when ONRR receives the lessee's notice of appeal of the order, which is at least 30 days, and often longer, after the order is issued. 43 C.F.R. § 4.904.
- By statute, lessees have 180 days to seek court review of adverse final orders. 30 U.S.C. § 1724(j).
- Differences over when the period ends have already led to needless litigation over the timeliness of a lessee's suit. *Continental Res. Inc. v. Jewell*, 846 F.3d 1232 (D.C. Cir. 2017).
- Amend the regulation to comply with the Court's ruling in *Murphy*.

Potential Heavy Penalties for Harmless Conduct

Year	Submission/Maintenance Violation	Case	Citation
2019	Quinex Energy Corporation was assessed **$500,000** for "knowingly or willfully maintain[ing] false, inaccurate, or misleading royalty information in the ONRR Financial System" and "repeatedly failed to correct erroneous gas prices reflected in its ONRR-2014 reports."	CP12-089	https://www.onrr.gov/compliance/PDFDocs/2019.pdf at 2.
2015-2017	Gulfsands Petroleum, USA, was assessed **$58,630.53, $62,635.20, and $10,439.20** for "knowingly or willfully maintain[ing] false, inaccurate, or misleading information on ONRR's financial system for 20 sales months from January 2007 through August 2008."	CP13-099	https://www.onrr.gov/compliance/PDFDocs/2015.pdf at 2; https://www.onrr.gov/compliance/PDFDocs/2016.pdf at 2; https://www.onrr.gov/compliance/PDFDocs/2017.pdf at 3.
2016	Chesapeake Energy was assessed **$2,118,900** for "knowingly maintain[ing] inaccurate information on ONRR's database pertaining to royalty and/or production reports on two leases for 13 months."	CP14-004	https://www.onrr.gov/compliance/PDFDocs/2016.pdf at 2.
2014	Patara Oil and Gas, LLC, was assessed **$40,500** for "knowingly or willfully maintain[ing] inaccurate oil and gas volume information reported on production and/or royalty reports for a period of six months on ten properties."	CP13-109	https://www.onrr.gov/compliance/PDFDocs/2014.pdf at 1.
2014	Chesapeake Energy was assessed **$765,000** for "knowingly or willfully submit[ing] inaccurate royalty report information on one Federal lease for 15 months."	CP13-009	https://www.onrr.gov/compliance/PDFDocs/2014.pdf at 2.

Potential Heavy Penalties for Harmless Conduct

Year	Submission/Maintenance Violation	Case	Citation
2013	Dynamic Offshore Resources, LLC, was assessed **$780,300** for "knowingly or willfully maintain[ing] inaccurate royalty information on ONRR's Financial System pertaining to 3 Offshore leases for 51 months."	CP12-180	https://www.onrr.gov/compliance/PDFDocs/2013.pdf at 1.
2012	Chevron U.S.A. was assessed **$107,200** for "knowingly maintain[ing] inaccurate data pertaining to one royalty and one production report on ONRR's Financial System for a 18-month period."	CP12-042	https://www.onrr.gov/compliance/PDFDocs/2012.pdf at 1.
2012	Chevron U.S.A. was assessed **$539,000** for "knowingly maintain[ing] inaccurate data pertaining to 11 royalty reports on ONRR's Financial System for a 16-month period."	CP12-041	https://www.onrr.gov/compliance/PDFDocs/2012.pdf at 1.
2012	QEP Energy Company was assessed **$1,207,800** for "knowingly maintain[ing] inaccurate oil and gas volume information pertaining to 953 royalty and/or production reports on 35 leases for as many as 22 months."	CP11-091	https://www.onrr.gov/compliance/PDFDocs/2012.pdf at 2.
2012	BP America was assessed **$5,189,800** for "knowingly or willfully submit[ing] at least 21 false, misleading, or inaccurate royalty reports during 2009."	CP07-040	https://www.onrr.gov/compliance/PDFDocs/2012.pdf at 4.