United States Department of the Interior

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Memorandum

To: Deputy Associate Director for Compliance
Deputy Associate Director for Valuation and Operations

From: Associate Director for Royalty Management James W Shaw

Subject: Valuation Guidance for Auditing Affiliate Sales of Coal

The attached guidance paper replaces the guidance paper dated October 18, 1996. The paper provides guidance for you to follow when auditing royalties for affiliate sales of coal produced from Federal and Indian leases under the current regulations. The only difference between the two papers is that the references to the memoranda issued by the Assistant Secretary - Land and Minerals Management on October 14 and December 12, 1988, have been deleted. Address any questions about the policy to the Chief, Valuation and Standards Division.

Attachment

November 26, 1996

GENERAL VALUATION GUIDANCE FOR AUDITING AFFILIATE SALES OF COAL

GUIDANCE:

Arm's-length Contracts

The value of coal sold under an arm's-length contract is generally the gross proceeds accruing to the lessee. If the arm’s-length contract does not reflect the total consideration for the value of production received by the lessee, then value may be determined under the valuation benchmarks 30 CFR § 206.257 (c) (1996). The lessee’s gross proceeds may not be reduced by the costs of placing production in marketable condition.

Non-arm's-length Contracts

The value of coal sold under a non-arm's-length contract or not sold at all is determined by the benchmarks as described in Attachment 1 - Applicable Regulations, Policies, and Case History.

A sale from the lessee to another party (such as a joint venture) in which the lessee has an ownership percentage between 10 percent and 50 percent in that party would be presumed to be a sale between affiliates. Any argument that valuation in this situation is arm’s-length would require rebuttal of the presumption of control and demonstration of an opposing economic interest.

Regardless of the benchmark value chosen, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee.

If the resale of production from the affiliate to a third party occurs in the same field or area as the sale from the lessee to its affiliate, the proceeds under the arm’s-length resale contract may be used in calculating the applicable benchmark value.

The affiliate’s records may be examined in order to determine if the affiliate performed services that are the responsibility of the lessee to perform at no cost to the lessor or whether the affiliate received additional consideration for the value of production that should be part of the lessee’s gross proceeds. Specific guidance on determining the lessee’s gross proceeds after examining the affiliate’s records cannot be detailed here. Such determinations must be made on a case-by-case basis taking into account services necessary to place the production in marketable condition or to market the production, the location of the resale, and other relevant matters.

RATIONALE FOR GUIDANCE:

The concept that royalty value cannot be less than the gross proceeds accruing to the lessee is an underlying principle of the coal valuation rules. The recent Shell Interior Board of Land Appeals decision (132 IBLA 354) underscores the Minerals Management Service’s (MMS) right to determine what the lessee's gross proceeds are, even after an interim transfer of production to an affiliate. In its brief before the IBLA in the Shell case (132 IBLA 354, decided May 11, 1995, on reconsideration), MMS argued that nowhere in the 1988 rules or rulemaking history is there any restriction against MMS looking to an affiliate's arm's-length sales of production. The MMS has authority under its regulations, and as confirmed by IBLA in the circumstances present in the Shell case, to compare the value properly determined under the first applicable benchmark to the lessee's gross proceeds and select the higher of the two. Sales by affiliates may provide information concerning gross process to the lessee and the appropriate benchmark value in some situations and thus may be considered in determining royalty value.

PROCEDURES:

Arm's-Length Contracts

As a general practice, gross proceeds under an arms-length contract are determined by the sales contract and revenue accounts representing consideration actually received. Any differences between contract values and amounts actually received may represent additional consideration paid for the value of coal production. Royalty value is determined by the total consideration received or accruing under the contract or otherwise, less allowable costs of transportation under MMS regulations. Reviews or audits of coal gross proceeds should include a verification of all relevant documents such as revenue account bookings and/or purchaser statements.

Non-arm's-length Contracts

As a general practice, royalty value for a non-arm’s-length sale or transfer is determined by application of the benchmarks. The first applicable valuation benchmark is used to determine the royalty value. However, under no circumstances can value be less than gross proceeds accruing to the lessee. Royalty value is determined by the higher of consideration received by the lessee less allowable costs of transportation under MMS regulations, or the applicable benchmark value. Reviews or audits of coal gross proceeds may include a verification of all relevant documents of the lessee or its affiliate, as well as records of arm's-length purchasers not affiliated with the lessee. Relevant documents may include revenue account bookings and/or purchaser statements.

Because coal production from Federal and Indian leases is not subject to FOGRMA, lease terms may be invoked as a basis for accessing records of an affiliate. Specifically, coal lease terms state at Section 6, ". . . lessee shall furnish detailed statements showing the amount and quality of all products removed and sold from the lease, the proceeds therefrom, and the amount used for production purposes or unavoidably lost." Further, at Section 11, coal lease terms state, " . . . If the lessee fails to comply with the applicable laws, existing regulations, or the terms, conditions, and stipulations of this lease, and the noncompliance continues for 30 days after written notice thereof, this lease shall be subject to cancellation by the lessor only by judicial proceedings. This provision shall not be construed to prevent the exercise by lessor of any other legal and equitable remedy, including waiver of the default . . . ." (Emphasis added). Auditors should refer any requests for enforcement of these lease terms to the Office of Enforcement.

TIME PERIODS:

Decisions about how far back MMS would assess royalties for coal undervaluation under the current regulations are subject to the Director's July 14, 1995, guidelines regarding audit timing and resource allocation.

Attachment 1

APPLICABLE REGULATIONS, POLICIES, AND CASE HISTORY:

The regulations at 30 CFR § 206.257 (g) (1996) state, in part,

> Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.

Regulations found at 30 CFR§ 206.257 (c)(2) (1996) specify the procedure required to value coal sold under non-arm's-length conditions. This coal must be valued using a benchmark system, using the first benchmark first, the second next if the first does not apply, and so forth. The first benchmark is found at 30 CFR **§** 206.257 (c)(2)(I) (1994) and states:

> (I) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition of produced coal by other than an arm's-length contract), provided that those gross proceeds are within the range of the gross proceeds derived from, or paid under, comparable arm'-length contracts between buyers and sellers neither of whom is affiliated with the lessee for sales, purchases, or other disposition of like-quality coal produced in the area . . .;
>
> (ii) Prices reported for that coal to a public utility commission;
>
> (iii) Prices reported for that coal to the Energy Information Administration of the Department of Energy;
>
> (iv) Other relevant matters including, but not limited to, published or publicly available spot market prices or information submitted by the lessee . . .;
>
> (v) If a reasonable value cannot be determined using paragraphs (c)(2)(I),(ii), (iii), or (iv) of this section, then a net-back method or any other reasonable method shall be used to determine value.

The October 14, 1993, policy paper, *Valuation of Sales to Affiliates*, states that

> When applying the benchmarks, it is necessary to consider the gross proceeds requirement discussed previously. Gross proceeds may not be reduced by costs to place the product in marketable condition or marketing costs . . . .

> If the resale from the affiliate to a third party occurs in the same field as the first sale from the lessee to the affiliate and if the affiliate is performing services other than transportation or processing (i.e., marketing services), the resale price would represent the minimum value for royalty purposes under the gross proceeds requirement.

In Santa Fe Energy Products Co., 127 IBLA 265, 268 (1993), the Board affirmed MMS's

> . . .authority [under the Federal Oil and Gas Royalty Management Act (FOGRMA)] to obtain records from any affected person involved in purchasing or selling oil, and that MMS is not limited to dealing exclusively with the signatory lessee concerned. . . . [Therefore,] . . . the obligation to report "gross proceeds accruing to the lessee" cannot be avoided by an inter-affiliate transfer made in contemplation of later sale to third parties.

In Santa Fe Energy Products Company, No. 95-1221, Tenth Circuit, April 10, 1996, the Court of Appeals stated:

> Under the gross proceeds rule, the MMS could reasonably require information relating to Products' sales in order to ascertain the oil's fair market value and to determine the gross proceeds accruing to Energy . . . . The MMS' determination that the first arm's-length sale of oil produced under a federal lease was covered by the "other relevant matters" language of its regulations was not arbitrary, capricious, or contrary to law . . . . Products is a wholly owned affiliate of Energy. Accordingly, Products sales were relevant to determining gross proceeds accruing to Energy . . .

In Shell Oil Co. (on reconsideration) 132 IBLA 354, the IBLA ruled that:

> Consequently, no matter what regulatory benchmark is used to determine royalty, MMS must compare the result obtained thereby against a gross proceeds analysis in any case . . . .
>
> Upon reconsideration of the question whether MMS had authority to require disclosure of information regarding the transfer of production to Shell in this case, therefore, we find that the marketing affiliate distinction, upon which the Shell decision turned, had no relevance to the question whether the gross proceeds rule must first be applied . . . .
>
> Contrary to the argument advanced by Shell, therefore, the policy paper also indicated that there is an obligation and an expectation that MMS will look beyond the inter-affiliate transfer to determine whether other factors affect product value. As suggested in Santa Fe [127 IBLA 265, 1993], affiliates participating in a transfer of Federal lease production in contemplation of sales to a third party should expect MMS to scrutinize an inter-affiliate transfer and all subsequent affiliate sales.

The IBLA goes on to say at 132 IBLA 357:

> The term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee. [30 CFR § 206.101 (1996) (lessee).]

In Xeno, Inc. 134 IBLA 172 (November 14, 1995), the IBLA ruled that:

> The sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of produced gas under the gross proceeds rule.