OIL RIK VALUE AND VOLUME REPORTING RECOMMENDATIONS

by

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EXECUTIVE SUMMARY

In June 1996 the Royalty Policy Committee (RPC) recommended that the Minerals Management Service (MMS) review the oil Royalty-In-Kind program (RIK), stating that "The current method of administering the Federal oil RIK program is time consuming and burdensome on producers, small refiners[1], and MMS." As a result of this recommendation and MMS's desire to streamline and simplify the oil RIK program, MMS formed a team to study ways to improve the program. The study team has completed the first phase of its study, which is reported below. The team identified program changes to address concerns with the program and recommends a pilot study to test the proposed changes. (See Chapter 1.)

The second phase of the study will address program administration issues involving such matters as the process for making a Determination of Need and calculation of the administrative fee. This phase is targeted for completion by December 31, 1997.

Background

The mechanics of the current oil RIK program are (see Chapter 2):

- The lessees report royalty volumes and the associated values to MMS on the *Report of Sales and Royalty Remittance* (Form MMS-2014) at the end of the month following the month of production. The reported volumes are based on royalty entitlements and usually do not match exactly the deliveries to the refiners.

- The Auditing and Financial System sorts the Form MMS-2014 data and prepares the refiners' bills, which are processed and mailed by the 15th day of the second month following the month of production.

- The refiners pay the billed amounts by the end of the second month following the month of production.

Some of the more serious problems identified by MMS, the RPC, the refiners, and/or the lessees/operators, include:

- The royalty oil value billed under the contract is not necessarily a final value, being subject to audit and/or subsequent adjustment. This valuation method creates risk for the refiner and imposes administrative burden on the lessees and MMS. (See Chapter 2 and Appendix A.)

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[1] The technically correct term is "eligible refiners" (see footnote 5 in Chapter 2 of the report). The term "refiner" in this summary and the report means eligible refiner.

- An entitlement-based program often causes large imbalances between volumes of oil for which a refiner is billed and the volumes it actually receives in a given month. (See Chapter 2 and Appendix C.)

- Offshore delivery points are not always at facility measurement points with royalty meters (FMP) causing further volume imbalances, gravity differences, and program administration burdens involving transportation. (See Chapter 2 and Appendix C.)

- Payments for RIK oil volumes are received 1 month later than they would have been received had they been in-value payments -- resulting in a cash surety requirement and an increase in the overall administrative cost of the current program. (See Chapter 2.)

Recommendations

The study team recommends the following:

- Revise the valuation methodology for RIK leases to bring about price certainty. The team is working with the Royalty Valuation Division to determine a methodology that will provide certainty while complying with applicable statutes. An underlying premise of this approach is that the valuation methodology will be specified in the contract. (See Chapter 1.)

- Direct the lessee to deliver the royalty share of offshore crude oil production to the refiner as the oil flows through the royalty meter at the FMP nearest the lease. For onshore oil the lessee will continue to deliver the oil at or near the lease pursuant to the terms of the lease. (See Chapters 1 and 3 and Appendix C.)

- Terminate lessee reporting of royalty volumes and values and require refiners to report and pay for delivered royalty oil (as herein defined) using the price specified in the RIK contracts. (See Chapters 1 and 3.)

The above program changes will re-engineer and streamline the current oil RIK reporting and accounting process. The refiner will report, either on the Form MMS-2014 or on another vehicle, its allocated share of production at the FMP (deliveries) using an RIK valuation methodology that offers price certainty. The study team expects deliveries to approximate entitlements, thereby minimizing volume imbalances because the refiner will be taking the royalty share of production as it passes through the royalty meter. (See Chapter 3.)

The refiner will pay only for its deliveries each month versus paying on the royalty volumes reported by the lessees. The MMS will not issue RIK bills and lessees will not report on the Form MMS-2014. Even though the reporting recommendation is for the refiner to report and pay without the need for a billing function, a modified billing option will be studied in a pilot mode to assess its feasibility in comparison to the refiner reporting mode. (See Chapters 3 and 4.)

In most cases, the lessees will deliver the royalty share of crude oil production from or attributable to a lease (royalty oil) to the purchasing refiner at a designated delivery point at or near the lease. Title to the royalty oil will transfer to the refiner at the delivery point. The refiner will be required to accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The refiner will be responsible for all issues and costs downstream from the point of delivery and will assume all associated risks. (See Chapter 3.)

The MMS will compare the offshore sales volumes reported by the operator to the Production Accounting and Auditing System or the Offshore Minerals Management (OMM) Liquid Verification System (see footnote 3, Chapter 1) with the delivered volumes reported by the refiner. A preferred comparison method will be determined in the pilot study. The MMS will continue to perform onshore volume comparisons as it does now, using the volumes reported by the refiner. The MMS will begin the comparisons as soon as the production data is available and will work with the lease operator and/or lessee, and, if necessary, the refiner to resolve significant volume discrepancies as soon as they are identified. The lessee and refiner will settle volume discrepancies in kind during the term of the contract. The MMS will address minor variances either annually or after the contract is terminated. (See Chapter 3.)

The RIK contract will specify reporting and paying requirements which, if not followed, may result in assessment of interest or penalties or in contract termination. Refiner reports and substantiating records will be available for audit by MMS. However, the audit period will be clearly defined. (See Chapter 3.)

Pilot Study

The study team recommends MMS conduct a pilot study for selected offshore and onshore leases, where feasible and meaningful, with selected refiners, lease operators, FMP operators, lessees, and OMM. The pilot will be run parallel to the current reporting and billing process with no change to current billing, reporting, and paying procedures. The pilot will afford all parties the opportunity to evaluate the viability of the proposed recommendation and to modify it, where necessary, before implementing new oil RIK program procedures. The pilot will enable MMS to assess the feasibility of several reporting options such as: (see Chapter 4)

- Refiner to report bulk volumes delivered at the FMP without respect to property allocation.

- Refiner to report volumes allocated to property.

- MMS to bill for royalty oil based on the OMM Liquid Verification System.

Members of the study team held preliminary discussions about the pilot with a representative of the Office of the Solicitor and with OMM's Chief, Surface Commingling and Production Measurement Section, Office of Production Development, and members of his staff. The former

had no major concerns with the operational aspects of the pilot but supported the team's proposed recommendation that a pilot study plan be developed and reviewed prior to implementation. The OMM representatives provided an overview of the Liquid Verification System and offered their support for the pilot. (See Chapter 1.)

When the pilot study is completed and a new oil RIK program approved, new regulations will be issued, contract terms written, and procedures revised, as necessary. All of the current oil RIK contracts terminate by May 1999. Should a Determination of Need recommend continuation of the oil RIK program, the new program will be implemented. (See Chapter 4.)

Implementation of a new reporting methodology, should the pilot prove successful, is contingent upon a revision to the current valuation methodology for RIK leases. If MMS has not adopted a method that will achieve price certainty, the study team recommends that the lessees continue reporting RIK volumes and the associated values on Forms MMS-2014 and that MMS continues billing the refiners for entitled volumes. However, the team recommends that the delivery points for offshore royalty oil be moved from onshore delivery points, where so designated, to the FMP's at or near the leases where feasible. Also, the team recommends that the lessees be required to deliver the royalty share of production to the refiners as it passes through the royalty meters at the FMP's. (See Chapters 1 and 3.)

Benefits

The study team believes that the preferred option discussed in Chapter 3 would bring the following specific benefits to the Government: (see Chapter 3)

- It positively responds to concerns expressed by the RPC, refiners, lessees, and operators about administrative burdens, inefficiencies, and cost burdens of the current oil RIK program.

- It reduces risk of nonpayment to the Government by establishing price certainty and eliminating the need for audit or review beyond a relatively short period of time.

- It re-engineers the RIK process and proactively involves MMS in resolving volume imbalances in a timely manner.

- It reduces financial risk to the Government by enabling collection of any additional amounts due in a relatively short period of time.

CHAPTER 1

Introduction

In June 1996 the Royalty Policy Committee (RPC) recommended that the Minerals Management Service (MMS) review the oil Royalty-In-Kind program (RIK). The RPC's report states:

> The current method of administering the Federal oil RIK program is time consuming and burdensome on producers, small refiners, and MMS. The administrative burden includes reconciling what volumes the small refiner actually took, what value to assign to the small refiner volumes, who paid for what volumes, and who owes for what volumes.

The RPC recommended MMS study options to improve the oil RIK program such as:

- Eliminate reporting on the *Report of Sales and Royalty Remittance* (Form MMS-2014). [1]
- Establish product value in the RIK contract.
- Bill entitled volumes from the *Oil and Gas Operations Report, Form MMS-OGOR* (OGOR) and/or *Monthly Report of Operations* (Form MMS-3160). [2]

As a result of this recommendation and MMS's desire to streamline and simplify the oil RIK program, an oil RIK study team (study team) was formed to identify and evaluate ways to:

- Simplify Form MMS-2014 reporting.
- Eliminate volume discrepancies inherent in the current oil RIK program.
- Eliminate the revenue receipt delays in the current oil RIK program.
- Reduce administrative burden as much as possible for all parties.
- Streamline and re-engineer the current process with minimum costs.

The study team was organized in September 1996 and is composed of the following members, seven of whom are MMS employees and two of whom are State 205 audit employees:

- James Alexander, Compliance Verification Division, Financial Compliance Branch
- Randy Bolles, Wyoming 205 Audit Office (joined the team in December 1996)
- Donald Gilman, Accounting and Reports Division, Financial Branch

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[1] This report is used by lessees to report monthly sales and royalty information to MMS.

[2] These reports are used by operators to report monthly production information to MMS. The OGOR is used primarily for offshore leases and the Form MMS-3160 is used only for onshore leases.

- Vernon Ingraham, Accounting and Reports Division
- Cherry Mallard, Office of Enforcement
- James McNamee, Policy and Management Improvement
- Paula Neuroth, Accounting and Reports Division, Reports Branch
- Donald Pagliasotti, Compliance Verification Division, Production Accountability Branch (joined the team in December 1996)
- George Staigle, North Dakota 205 Audit Office

During September and October 1996 the study team focused on valuation issues and recommended to the Royalty Valuation Division that the proposed rulemaking for crude oil valuation, then being drafted, be modified to incorporate valuation provisions specific to RIK leases. The MMS management agreed with this recommendation and the proposed rulemaking was modified to incorporate provisions that specifically addressed the valuation methodology for leases in an RIK status. There were several responses to this proposed rulemaking, and the team currently is working with the Royalty Valuation Division to analyze the responses and decide whether to adopt the proposed methodology or propose a different one. These responses are summarized in Appendix A.

Implementation of the study team's preferred option for administering the oil RIK program is contingent on MMS establishing value (price per barrel) for RIK purposes and specifying the valuation procedure in the RIK contract. If MMS cannot develop a pricing methodology that will achieve certainty of pricing at the time of payment, the team recommends that the lessees continue reporting RIK volumes on the Form MMS-2014 and MMS continues billing the refiners for entitled volumes. However, no matter what happens with the valuation methodology, the team recommends that the delivery points for offshore volumes be moved from onshore delivery points, where so designated, to the offshore facility measurement point royalty meters (FMP) at or near the leases, where feasible.

In November 1996 the study team began its review of volume issues. The following reporting options summarize the results of this review. Options 1 through 4 are presented in Appendix B. Option 5 is the study team's preferred option and is discussed in Chapter 3.

1. MMS bills the refiner based on data reported on OGOR's/Forms MMS-3160.
2. Lessee reports based on the refiner's allocated share of production at the FMP (hereinafter referred to as deliveries).
3. Refiner reports and pays based on entitlements.
4. Status quo with delivery point at or near the lease.
5. Refiner reports and pays based on deliveries with the delivery point at or near the lease.

During the course of this review, the study team held three feedback sessions with refiners. The latter two of these sessions also included lessees and operators. The sessions were held December 17, 1996; March 26, 1997; and May 20, 1997.

The session participants had no decision-making role in the study team's review. Also, while each participant provided valuable feedback to the team during these sessions, no voting or other decision-making processes were invoked. The sessions were strictly for feedback that the team could use or not use in its review of the issues.

The following organizations were represented in one or more of the sessions.

Refiners:	AGE Refining, Inc. Gary-Williams Energy Corporation Giant Industries Arizona, Inc. U.S. Oil & Refining Company Wyoming Refining Company
Lessees/Operators:	Chevron Production Company Exxon Company, U.S.A. Mobil Business Resources Corporation Texaco Exploration and Production Inc.
Associations:	American Petroleum Institute Council of Petroleum Accountants Societies Independent Petroleum Association of Mountain States Rocky Mountain Oil and Gas Association

At the March 26, 1997, refiner/operator session the reporting options were discussed. The location of the offshore delivery point was stated by many of the participants to be a primary factor associated with volume balancing problems in the current RIK program. At the May 20, 1997, refiner/operator session the study team sought additional feedback on options that addressed delivery point and lessee vs. refiner volume reporting issues. Option 5 above was used for obtaining feedback on these issues.

While the study team believes that Option 5 is feasible, it recognizes that the option has been developed in a theoretical environment. Therefore, the team recommends that MMS conduct a pilot study that will enable MMS, operators, and refiners to assess the feasibility of implementing this option.

Several modifications of Option 5 will be tested in the pilot, including (see Chapter 4):

- Refiner reports the bulk volumes delivered at the FMP without respect to property allocation;

- Refiner reports volumes allocated to properties (i.e., accounting identification numbers); and

- MMS bills the refiner based on Offshore Minerals Management's (OMM) Liquid Verification System (LVS)[3] production volumes.

Members of the study team held preliminary discussions about the pilot with a representative of the Office of the Solicitor and with OMM's Chief, Surface Commingling and Production Measurement Section, Office of Production Development, and members of his staff. The former had no major concerns with the operational aspects of the pilot but recommended a pilot plan be developed and reviewed prior to pilot implementation. The OMM representatives provided an overview of the LVS and offered their support for the pilot.

The study team will make a recommendation for implementing or not implementing the preferred option at the conclusion of the pilot.

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[3] The Liquid Verification System is a combination of automated and manual processes that calculates and compares volumes of oil and condensate measured at Outer Continental Shelf (OCS) FMP's to the sales volumes reported for each FMP by operators of OCS leases and agreements on their OGOR's. The LVS data base is populated with original source document information such as run tickets.

CHAPTER 2

Current Oil RIK Program

The October 1, 1997, status of RIK contracts [4] will be as follows:

	Number of Contracts	Number of Refiners	Number of Leases
Onshore	1	1	41
Offshore	6	5	171
Total	7	6	212

The onshore contract was signed in 1987, has been in force continuously since then and is scheduled to terminate July 1, 1998. The offshore contracts were signed in 1994 and 1995 and are scheduled to terminate May 1, 1999. The RIK sales totaled $35.6 million in July 1997 compared to $130.3 million in oil royalties (including RIK) collected for that month. For July, oil RIK represented 27.3 percent of total oil royalties. This is down from about 40 percent for fiscal year 1996.

The oil RIK program is governed by the regulations at 30 CFR 208, which were promulgated December 1, 1987 (52 F.R. 41908). The program is authorized by the *Mineral Leasing Act of 1920* (MLA), as amended (30 U.S.C. § 192) and the *Outer Continental Shelf Lands Act* (OCSLA) of August 7, 1953, as amended (43 U.S.C. § 1334, 1353). The acts authorize the

[4] Effective August 1, 1997, one offshore contract with 34 leases terminated and one offshore contract dropped one lease; effective October 1, 1997, one onshore contract with 10 leases will terminate and one offshore contract will drop one lease. As of October 1, 1997, there will be seven RIK contracts with six refiners.

Secretary of the Interior to take Federal royalty oil in kind and sell it to "eligible refiners"[5] (herein referred to as refiners) for use in their refineries.

The MLA states:

> . . . inasmuch as the public interest will be served by the sale of royalty oil to refineries not having their own source of supply for crude oil, the Secretary of the Interior, when he determines that sufficient supplies of crude oil are not available in the open market to such refineries, is authorized and directed to grant preference to such refineries, in the sale of oil under the provisions of this section, for processing in such refineries and not for resale in kind, and in so doing may sell to such refineries at private sale at not less than the market price any royalty oil accruing or reserved to the United States under leases issued pursuant to this chapter . . . . (30 U.S.C. § 192)

The OCSLA states:

> Whenever, after consultation with the Secretary of Energy, the Secretary determines that small refiners do not have access to adequate supplies of oil at equitable prices, the Secretary may dispose of any oil which is taken as a royalty or net profit share accruing or reserved to the United States pursuant to any lease issued or maintained under this subchapter . . . by conducting a lottery for the sale of such oil, or may equitably allocate such oil among the competitors for the purchase of such oil, at the regulated price, or if no regulated price applies, at its fair market value. (43 U.S.C. § 1353)

The regulations at 30 CFR 208.4(b)(2) state that all sales of royalty oil from onshore leases will be priced ". . . at the royalty value that would have been determined for that oil pursuant to 30 CFR part 206 had the royalties been paid in value rather than taken in kind." They further

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[5] As defined in 30 CFR 208.2, the term "eligible refiner" means a refiner of crude oil that meets the following criteria for eligibility to purchase royalty oil:

> (1) For the purchase of royalty oil from onshore leases, it means a refiner that qualifies as a small and independent refiner as those terms are defined in sections 3(3) and 3(4) of the Emergency Petroleum Allocation Act, 15 U.S.C. 751 *et seq*., except that the time period for determination contained in section 3(3)A would be the calendar quarter immediately preceding the date of the applicable "Notice of Availability of Royalty Oil." A refiner that, together with all persons controlled by, in control of, under common control with, or otherwise affiliated with the refiner, inputs a volume of domestic crude oil from its own production exceeding 30 percent of its total refinery input of crude oil is ineligible to participate in royalty oil sales under this part. Crude oil received in exchange for such refiner's own production is considered to be that refiner's own production for purposes of this section.
> (2) For the purchase of royalty oil from leases on the OCS, it means a refiner that qualifies as a small business enterprise under the rules of the Small Business Administration (13 CFR part 121).

state that sales of royalty oil from OCS leases will be priced ". . . at the fair market value[6] of the oil including associated transportation costs to the designated delivery point, if applicable."

When the Secretary determines that the need for an RIK sale exists, MMS issues a "Notice of Availability of Royalty Oil" announcing the sale. The notice gives the parameters of the sale, approximate quantities being offered, application procedures, and other general administrative details. The Royalty Management Program (RMP) selects leases for the sale based on various criteria, one of which is average daily production. For the 1987 and 1994 sales, the minimum daily production volumes were 10 barrels per day for onshore wells and 50 barrels per day for offshore wells.

During the RIK sale, the refiners are allocated volumes of royalty oil from the pool based on their needs, capacity criteria,[7] and the available volumes. The order of selection is determined by lottery, with the refiners selecting leases in sequence to make up their allocated volumes. In previous sales the first refiner in the lottery selected all of its leases before the second began to select, the third selected after the second, etc. When the sale is completed, RMP notifies the lessees of the selected leases when they must begin paying royalties in kind, who the refiners are to which the oil is to be delivered, and what the delivery points will be.[8] The lessees also are notified to begin reporting the RIK volumes and values as transaction code 06 (RIK) and payment method 04 (in kind) on Forms MMS-2014 after the contracts begin.

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[6] As defined in OCSLA and 30 CFR 208.2, the term "Fair Market Value" means the value of oil:

> (1) Computed at a unit price equivalent to the average unit price at which oil was sold pursuant to a lease during the period for which any royalty or net profit share is accrued or reserved to the United States pursuant to such lease, or
> (2) If there were no such sales, or if the Secretary finds that there were an insufficient number of such sales to equitably determine such value, computed at the average unit price at which such oil was sold pursuant to other leases in the same region of the OCS during such period, or
> (3) If there were no sales of oil from such region during such period, or if the Secretary finds that there are an insufficient number of such sales to equitably determine such value, at an appropriate price determined by the Secretary.

[7] The refiner is not entitled to receive total lease volumes at the sale which exceed 60 percent of refinery capacity.

[8] The criteria for delivery points and procedures for transportation cost recoupment are at 30 CFR 208.8. In general, onshore delivery points are a point on or adjacent to the lease pursuant to lease terms. Offshore delivery points generally are designated by MMS, and can be on or adjacent to the lease or at a downstream custody transfer point. If downstream, MMS reimburses the lessee for the reasonable cost of transportation to the delivery point, not to exceed the transportation allowance determined pursuant to 30 CFR part 206.

The mechanics of the RIK program's reporting, billing, and payment are as follows:

- the lessees report royalty volumes and the associated values to MMS on Form MMS-2014, at the end of the month following the month of production;
- the Auditing and Financial System (AFS)[9] sorts the Form MMS-2014 data and prepares the refiners' bills, which are processed and mailed by the 15th day of the second month following the month of production; and
- the refiners pay the billed amounts by the end of the second month following the month of production.

The billed volumes are based on royalty entitlements and usually do not match exactly the deliveries to the refiners. The reason for this is that offshore deliveries are based on production estimates made prior to the month of production and generally not adjusted during the production month to reflect actual entitlements.[10] The imbalances are made up at a later date; however, the refiners pay for any under delivered volumes when they pay for the entitled volumes reported on the Form MMS-2014.

For onshore deliveries, the royalty oil often remains in storage on the lease until the refiner picks it up. This could cause deliveries to be made up to 30 days following the month of production, although the refiner is billed for the royalty oil as if it were delivered in the month of production. In addition, if a lessee does not report, the AFS will generate an estimate based on prior history and the refiner will be billed for the estimated amount. There can be several reasons for the non-report, such as zero production or a non-documented selling arrangement change, but the result usually is detrimental to the refiner in the short term.

Another major concern for the refiners is that the billed values are subject to audit and/or further adjustment, as is also the case when lessees pay royalties in value. This causes uncertainty and risk for the refiners, who could be billed an increased amount for royalty oil several years after the oil was purchased. This also creates concern for the lessees because, under the provisions of 30 CFR 208.13 (b), the lessee could be liable for payment of any under billed amounts caused by the lessee's under reporting or failure to report if the under billed amounts are unrecoverable from the refiner or the contract surety. In addition, the Government is at risk given the uncertainty of the

[9] AFS is the financial accounting system used to receive and account for mineral revenues reported and paid; distribute and disburse revenues to legally entitled recipients; maintain a general ledger and receivables and payables accounts; conduct financial exception processing to identify late payment, underpayment, and nonpayment of revenues due; bill for additional revenues and late payment interest; and calculate interest due lessees on overpayments.

[10] See Appendix C for a discussion of volume balancing issues.

situation, particularly when either one or both the refiner and lessee are bankrupt or otherwise unable to pay.

Before the contracts begin, the refiners are required to post sureties to cover the estimated cost of 99 days worth of royalty oil, plus related administrative charges. If the refiner furnishes a letter of credit as a surety, it must be effective for a 9-month period beginning the first day of the contract . It also must contain a clause providing for automatic monthly renewal for a new 9-month period. Generally, the letter of credit is in effect for between 6 and 9 months following termination of the contract.

In addition to the above surety, the refiners must pay a "cash surety," which is an estimated payment for the first month's royalty oil. The payment, calculated by MMS, is due the end of the first month following the month of production. The payment is collected to eliminate the time delay for payments for in-kind royalty oil as compared to in-value royalties, and is distributed normally. The cash surety amount is credited to the bill for the final month's RIK entitlements.

The cash surety is required to maintain an uninterrupted cash flow because the refiners are billed for entitled volumes in the middle of the second month following the month of production, with payment due the end of that month. Normally, lessees make in-value payments in the month following the month of production. Therefore, without a cash surety, the Federal Government and the States, if applicable, would receive payment for royalty oil taken in kind 1 month later than they would have received the payment had the royalties been paid in value.

The MMS recovers its RIK program administrative costs through the collection of administrative fees based on actual program costs. The fees consist of an initial nonrefundable contract fee for each executed contract and a monthly charge applied to each lease under contract (administrative fee).[11] The amount of the initial contract fee is calculated prior to the sale and published in the "Notice of Availability of Royalty Oil," and is payable in equal installments due at the end of the first and second months of the contract. The monthly charges are billed and payable with the monthly royalty oil billings.

There are several problems with the current RIK program that have been identified by MMS, the refiners, the lessees, the operators, and RPC. Some of the more serious problems are:

- The royalty oil value reported by the lessees and billed to the refiners is subject to audit and adjustment, and may be adjusted several years after the initial billing.

- The refiners are billed based on royalty entitlements and not on delivered volumes. This can cause large imbalances between the volumes of oil for which a refiner is billed

[11] The contract fee for the contracts let in 1994 and 1995 was $20,000 per contract. The monthly administrative fee in Fiscal Year 1997 is $183.91 per lease.

and the volumes it actually receives in a given month, especially when the delivery point is not at or near the lease.

- Because lessees must report on Forms MMS-2014 and MMS must then bill the refiners, there is a time lag between when MMS receives payments for in-kind royalty oil versus when MMS would receive the payments if the royalties were being paid in value.

- The lessees contend that they should be relieved of any further royalty oil obligations once they have delivered the proper volumes of royalty oil in kind. They do not believe that they should be required to report value or be subject to the provisions of 30 CFR 208.13.

- When lessees must deliver oil from some offshore leases to onshore delivery points that do not have royalty meters, it creates the potential for gravity differences and imbalances between what the lessees report on Forms MMS-2014 and what the refiners receive. Also, the lessees must arrange for transportation to these points and then recoup the costs from MMS, both of which are administrative burdens they would rather forego. Finally, the lessees must assume the risk of loss when delivering to a point away from the FMP.

CHAPTER 3

Preferred Option

The study team identified and reviewed several options before selecting a preferred option. The options the team reviewed included:

1. MMS bills the refiner based on data reported on OGOR's/Forms MMS-3160.
2. Lessee reports based on the refiner's allocated share of production at the FMP.
3. Refiner reports and pays based on entitlements.
4. Status quo with delivery point at or near the lease.
5. Refiner reports and pays based on deliveries with the delivery point at or near the lease.

Options 1 thru 4 are discussed in Appendix B and summarized below. A detailed discussion of Option 5 follows this summary.

Option 1: <u>MMS bills the refiner based on data reported on OGOR's/Forms MMS-3160</u>

This option, while not recommended by the RPC, was specifically mentioned by it as a possibility for improving the oil RIK program. On the surface it has some appealing features such as eliminating Form MMS-2014 reporting by the lessees. However, there are certain problems with this approach that make it less than desirable.

Implementing this option would increase the current billing cycle by an additional 30 days, which would either delay disbursement to the States or result in an increased cash surety paid by the refiner. The billing delay would result because of the delayed Production Accounting and Auditing System (PAAS)[12] reporting cycle over the AFS reporting cycle.

In addition, bills based on OGOR's/Forms MMS-3160 probably would not be as complete as Form MMS-2014 based bills because of inherent process design that requires the entire production report to be accepted before the data can be used. In any given month an average of 10 percent of OGOR documents and 15 percent of Form MMS-3160 documents are on hold and not processed awaiting correction of erroneously reported data.

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[12] PAAS is the production accounting system used to collect and account for oil and gas well production volumes and disposition. Comparisons are made with sales volumes reported to the AFS to detect under reporting of royalty. Information is provided to the surface management agencies.

Further, system modification would be required to implement this option, which may be substantial. Such modifications to the AFS would be necessary to pull data from the OGOR's/Forms MMS-3160 for billing purposes. Additional modifications would be necessary for the Business Information System for statistical and informational reports that currently are not based on PAAS data.

Finally, this option does not address the issue of billing for deliveries versus entitlements. It does not change entitlement billing and thereby results in requiring payment from refiners for volumes not delivered timely.

Option 2: Lessee reports based on the refiner's allocated share of production at the FMP

This option requires lessees to continue reporting on the Form MMS-2014, along with the attendant administrative costs. It also increases the administrative burden on lessees. The RPC specifically stated that administrative burdens are a problem with the current oil RIK program and in need of reduction.

In addition, lessees would not necessarily know delivery information. This option would require them to obtain this information, which is an additional administrative burden. This task makes this option undesirable.

Option 3: Refiner Reports and Pays Based on Entitlements

While this option would eliminate reporting to MMS by the lessee, it would require that the lessee report entitled volumes to the refiner so that the refiner could report to MMS. This would increase industry's administrative burden. In effect, there would be no reduction in the lessee's administrative burden (in fact it could increase without standard and uniform Form MMS-2014 reporting requirements in place). The refiner's administrative burden would increase with little benefit. Reporting to MMS probably would be delayed because of the refiner's position as a middle person between the lessee and MMS.

Option 4: Status Quo With Delivery Point at or Near the Lease

If MMS did nothing else this would be an improvement to the current program. However, lessening the administrative burden, streamlining the reporting process, and enabling MMS to acquire information in a timely manner for volume balancing would not necessarily be accomplished by simply changing delivery points where feasible and possible.

Preferred Option 5: Refiner Reports and Pays Based on Deliveries with the Delivery Point at or Near the Lease

The study team is proposing to amend the way in which royalty oil is delivered in kind, reported, and paid. The team believes the proposed method, detailed below, will solve many of the

problems associated with the current oil RIK procedures. In particular, this approach will achieve the following benefits for refiners and lessees:

- Treat oil RIK in a commercial manner because refiners will pay for an allocated share of production at the FMP.
- Substantially eliminate volume imbalances where the delivery point is the FMP.
- Expedite resolution of volume imbalances when they do occur.
- Eliminate the delay in payment receipt and the need for a 30-day cash surety.
- Relieve the lessees of their royalty reporting burdens.
- Relieve the lessees from performing services downstream of the FMP in most cases.
- Establish price certainty.

Regarding this latter benefit, the preferred option, as discussed in Chapter 1, requires that the price being paid for royalty oil in a given month is known at the time that the refiner makes payment. (See also Appendix A.)

Specific benefits to the Government of this preferred option are as follows:

- Positively responds to concerns expressed by RPC, refiners, lessees, and operators about administrative burden, inefficiencies, and cost burdens of the current oil RIK program.
- Reduces risk of nonpayment to the Government by establishing price certainty and eliminating the need for audit or review beyond a relatively short period of time (i.e., within 1 year or less) to ensure that the royalty oil value is correctly reported.
- Streamlines the accounting process because it eliminates royalty reporting by the lessees and the billing of refiners by MMS.
- Proactively involves MMS in the resolution of volume imbalances in a timely manner, when such imbalances occur. This further reduces financial risk to the Government by enabling the collection of any additional amounts due in a relatively short period of time.

The study team provided refiner and lessee representatives the opportunity to comment on the preferred option, and received several comments.[13] In general, the respondents favor the option. In addition, members of the team held preliminary discussions about the preferred option and the proposed pilot with a representative of the Office of the Solicitor and with OMM's Chief, Chief, Surface Commingling and Production Measurement Section, Office of Production Development, and members of his staff. The former had no major concerns with the operational aspects of the pilot but recommended a pilot study plan be developed and reviewed prior to implementation. The OMM representatives provided an overview of the LVS (see footnote 3, Chapter 1) and offered their support for the pilot.

Preferred Option Procedures

The study team will test various methods for reporting and payment during the pilot study. The methods that are part of the preferred option are described in this section.

The refiner will report and pay for delivered volumes at the MMS-determined price. The refiner will pay only for what is delivered each month versus paying on entitled volumes. Because the refiner is reporting and paying, MMS will not issue RIK bills and lessees will not report on Form MMS-2014.

The proposed pilot study, outlined in Chapter 4, will include several options for assessing the feasibility of refiner reporting and paying versus MMS billing. These options expand on the preferred option and include a modified billing function to fully assess various possibilities. For example, pilot reporting and billing scenarios include (a) refiner reporting bulk volumes delivered at the FMP without respect to property allocation, (b) refiner reporting volumes allocated to property (i.e., by accounting identification number), and (c) MMS billing the refiners based on LVS reported volumes.

In most cases, the lessees will deliver the royalty share of oil production from or attributable to a lease (royalty oil) to the purchasing refiner at a designated delivery point on or near the lease[14]. Title to the royalty oil will transfer to the refiner at the delivery point. The refiner must accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The

[13] These comments are included in Appendix D along with the description of the option sent to the refiners, lessees, and operators.

[14] For offshore leases, the delivery point normally will be an offshore FMP that has a royalty meter approved by OMM. For onshore leases, the delivery point will be on or adjacent to the lease pursuant to the terms of the lease.

refiner will be responsible for all issues downstream (i.e., transportation, other costs, and disposition of the oil) from the point of delivery and will assume all associated risks.[15]

The lessee will notify the refiner of the estimated volume of royalty oil that will be available for delivery in accordance with its normal notification procedures in the month preceding the month of delivery. The lessee also will communicate to the refiner any circumstances other than routine production fluctuations that will affect royalty oil deliveries from the lease during the production month so that the refiner may adjust its transportation and other arrangements.

The lease operator will notify the refiner not later than 15 days prior to the end of the month following the month of production of the volumes and gravities that were allocated to the refiner's account. The notification will list the volumes and gravities by property[16] separately identifying lease basis wells, unit agreements, etc., that were allocated to the refiner's account. Based on this information, the refiner will report to MMS on a Form MMS-2014 its allocated volumes and gravities by lease and revenue source number.[17]

The refiner also will calculate the value of the royalty oil[18], enter it on the Form MMS-2014, and remit payment to MMS. The refiner will report and pay via electronic commerce by the end of the month following the month of production. The lessee no longer will report on the Form MMS-2014 for royalty oil taken in kind; however, the operator will continue to submit OGOR and/or Form MMS-3160 production reports.

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[15] Although the intent is to take most royalty oil as close to the lease as possible, MMS reserves the right to designate an onshore or other delivery point at any time. If the designated delivery point is on or near the lease, the lessee will deliver the royalty oil without cost to the Federal Government as an undivided share of production in marketable condition at pipeline connections or other facilities provided by the lessee, unless other arrangements are approved by MMS. If the delivery point is not on or near the lease, MMS will reimburse the lessee for the reasonable cost of transportation to such point.

[16] In other words, the volumes allocated to lease basis wells, unit agreements, etc., will be separately identified. This would be necessary should MMS adopt the reporting scenario requiring the refiner to report delivered volumes allocated to properties (i.e., by accounting identification number).

[17] The MMS will provide model Forms MMS-2014 and training in their use.

[18] The pricing formula for royalty oil purchased by a refiner under this program will be specified in the RIK contract. The formula to be used has not yet been established, but is being developed in conjunction with MMS's proposed oil valuation rule. The reported price will be verified by MMS within a reasonable period following the report month.

The MMS may continue to perform AFS/PAAS volume comparisons, but will begin to compare information as soon as the production data are available in MMS's automated system. The MMS will work with the lease operator and/or lessee, and if necessary the refiner, to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated. The lessee and refiner will settle volume discrepancies in kind during the term of the contract.

When balancing volumes are delivered in kind, the refiner will report a separate line on the Form MMS-2014 showing the month to which the adjusted volumes relate. The refiner will pay for the adjusted volumes at the price specified in the RIK contract.[19] If the contract is no longer in effect, the lessee will be required to settle imbalances in value.

The RIK contract will specify reporting and paying requirements that, if not followed, may result in assessing the refiner interest or penalties or in contract termination. Refiner reports and substantiating records will be available for audit by MMS. Any interest and/or penalties for the lessee's failure to satisfy its royalty obligations will be assessed in accordance with lease terms, statutes, and regulations.

The Pros and Cons associated with this option are as follows.

Pros

1. Lessees no longer have to submit Form MMS-2014 to report RIK volumes and the associated values.

2. The MMS will not issue RIK bills to the refiners.

3. Refiners pay only for the crude oil that they receive.

4. Volume differences at the delivery point should be minimal where such point is at or near the lease.

5. Payments will be received at the same time as they would have been received in value.

6. The AFS/PAAS comparison mechanism, or a similar mechanism, will continue to be used to determine correct reporting of volumes.

7. The 30-day cash surety can be eliminated, reducing the financial obligation of the refiner.

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[19] For example, adjusting volumes for the month of January that are delivered in April would be reported on the Form MMS-2014 submitted in May as a separate line item, identified as January deliveries.

8. Lessees' royalty obligations will be fulfilled when they have delivered the proper volumes, except for instances where imbalances are settled in value.

Cons

1. Refiners will have the added administrative burden of reporting deliveries to MMS.

2. The MMS will be involved in delivery imbalance issues, whereas currently its involvement is minimal.

3. The FMP operators or lease operators may be required to send FMP reports or allocation reports to the refiners.

4. Manual volume comparisons will be necessary prior to the scheduled AFS/PAAS system volume comparison, which is 6 months after the production month, unless a system modification is made.

CHAPTER 4

Proposed Pilot Study

As discussed in Chapter 3, the study team recommends its preferred option for further review in a pilot study. The pilot, should it be approved, will be conducted simultaneously with the current RIK reporting and accounting process. For example, lessees will continue to report entitled RIK oil volumes and values on the Form MMS-2014 and MMS will continue to bill the refiners for such volumes. The study team will work with MMS management prior to implementing the pilot to ensure its conformity with requirements for such studies.

The proposed pilot study will include several options for assessing the feasibility of refiner reporting and paying versus MMS billing. For example, offshore reporting scenarios include (a) refiner reporting bulk volumes delivered at the FMP without respect to property allocation and (b) refiner reporting volumes allocated to properties (i.e., accounting identification numbers). In addition, a modified billing scenario will be tested to compare with the current billing process and the preferred option. This scenario involves MMS billing for delivered/produced volumes based on LVS data. For onshore oil, the refiner will have to report volumes allocated to properties because of distribution implications.

The preferred option is a substantial change from the current oil RIK program. Because it addresses volume issues that create significant problems in the effective administration of an oil RIK program, sufficient time is needed to determine which process or processes can best overcome the problems. This will require close work with selected refiners, lease operators, FMP operators, and OMM.

In order to assess reporting and volume balancing issues over a reasonable period, including the comparison of reported delivered volumes with PAAS and LVS volumes, pilot reporting will occur over a 6-month period as defined below. The AFS/PAAS and AFS/LVS comparisons will be conducted on the information reported by the pilot refiners and operators. All volume discrepancies will be identified and reviewed. The study team will identify over and under deliveries and work with the participating refiners and operators in resolving balancing issues as quickly as possible.

Such reviews will begin the third month following the production month (the second month following the report month). The third month is the first point at which Form MMS-2014, OGOR/Form MMS-3160, and LVS information may be available for review. The reviews will terminate 3 months after pilot reporting has stopped. This will enable the first four pilot production months to be evaluated through the 6-month AFS/PAAS comparison cycle. This is necessary to allow sufficient time for volume corrections to be identified and reported on the Form MMS-2014 and OGOR reports. It also is needed to allow reasonable time for reports to be accepted by PAAS.

The pilot will be conducted with selected refiners and operators in the current oil RIK program. The leases selected for the pilot will include locations in the Gulf of Mexico. Some of the leases currently have onshore delivery points and others have offshore delivery points. The RMP will coordinate and work with OMM, refiners, lessees, and operators to determine which delivery points should be moved from a current onshore location to an offshore location. The pilot will contain a mixture of such delivery points in order to fully evaluate the volume balancing issue. In addition to the offshore leases, a sample of onshore leases in the RIK program will be selected for the pilot.

The FMP operator, lease operator, or MMS will be required to notify the refiner of actual volumes allocated to its account, depending upon the particular pilot reporting scenario. Specific timing and details may vary depending on which party provides information. This volume amount should be the actual volume and gravity flowing through the meter at the FMP. The report should specify volumes and gravities by property, separately identifying lease basis wells, unit agreements, etc., that were allocated to the refiner's account in those reporting/billing scenarios requiring this level of detail.

Based on this information, the refiner will report to MMS on the Form MMS-2014 or other reporting document (i.e., check stub) its (a) bulk volumes and gravities at the FMP and/or (b) allocated volumes and gravities by accounting identification number.

Pending adoption of a valuation methodology whereby price certainty can be achieved, a theoretical valuation approach will be adopted for purposes of the pilot in order for the refiner to assess its workload in calculating and reporting values to MMS.

The pilot will include the following steps:

1. Obtain management approval for the pilot including a determination that delivery reporting (as opposed to entitlement reporting) is acceptable. (September 1997)

2. Select refiners, leases, and operators for the pilot. (October 1997)

3. Move the delivery points for offshore leases from onshore to offshore locations, where necessary. (October-November 1997)

4. Establish participating refiners as recipients of FMP volume allocation reports to be provided directly to them by the FMP operator or lease operator. (November 1997)

5. Train participating refiners in reporting on the Form MMS-2014 and in using FMP and/or LVS reports. (October - December 1997)

6. First pilot production month. (January 1998)

7. Begin pilot reporting. (February 1998)

8. Begin volume reviews. (April 1998)

9. Last pilot production month. (June 1998)

10. End pilot reporting. (July 1998)

11. End volume reviews. (October 1998)

12. Complete pilot evaluation with refiners and operators. (November 1998)

13. Report results and recommendations to management. (December 1998)

14. Be prepared to implement new oil RIK program if a Determination of Need supports such action. (July 1999)

Any recommendations for system modifications will be folded into RMP's Program Re-engineering effort. The current RIK contracts will expire on their currently established end dates. The new RIK reporting and accounting process, should one be adopted, will be implemented after any system changes are made, contract terms are modified, regulations are revised, and a Secretarial Determination of Need has affirmed the need for an eligible refiner oil RIK program.

APPENDIX A

Valuation Proposal

The Minerals Management Service's (MMS) proposed rule for crude oil valuation was published January 24, 1997, and initially was closed for public comment on May 28, 1997. The MMS published a revision to certain aspects of this proposed rule on July 3, 1997, with an additional 30-day comment period. The proposed rule included provisions that specifically addressed the valuation methodology for leases in a royalty-in-kind (RIK) status. There were several responses to this proposed rulemaking, and the oil RIK study team currently is working with the Royalty Valuation Division to analyze the responses and decide whether to adopt the proposed methodology or propose a different one.

Following is a summary of the RIK valuation methodology included in the proposed oil valuation rule (January 24, 1997, Federal Register [volume 62, number 16, page 3742]), and a summary of the comments received.

Preamble regarding proposed change to 30 CFR 208.4(b)(2)

> MMS currently sells RIK crude oil to small refiners under the provisions of 30 CFR 208. The RIK program is popular, but has been criticized for several of its procedures. Much of the criticism stems from the fact that MMS prices the crude oil sold to small refiners at the values reported by the entities providing the in-kind crude oil (producers). These values are reported on Form MMS-2014, and are subject to later adjustments. This method is onerous to the producers and creates risk for the small refiners.
>
> The Royalty Policy Committee (RPC) provided three possible improvement options for the oil RIK program, as follows:
>
> - Eliminate reporting on the Form MMS-2014;
> - Establish product value in the RIK contract; and
> - Bill entitled volumes from the *Monthly Report of Operations* (Form MMS-3160).
>
> The RPC gave the following reason for its recommendations: The current method of administering the Federal oil RIK program is time-consuming and burdensome on producers, small refiners, and MMS. The administrative burden includes reconciling what volumes the small refiner actually took, what value to assign the small refiner volumes, who is to pay for what volumes, and who owes for what volumes.
>
> MMS's proposal would tie RIK valuation to the index pricing provisions of 30 CFR 206.102(c)(2). MMS believes that changing the oil RIK valuation procedures as proposed would provide a cornerstone for a revised oil RIK program. In particular, the changes would provide certainty in pricing and would

simplify reporting for producers. However, MMS realizes that the proposed change is significant, and requests comments on the proposal. In particular, MMS requests comments from crude oil producers and small refiners as to the impacts of the proposal on them. In addition, MMS requests comments from interested parties as to whether this proposed method of valuation would meet the fair market value definition of the *Outer Continental Shelf (OCS) Lands Act*[1].

Proposed Rule: 30 CFR.208.4(b)(2)

Effective with sales of royalty oil for the first full production month after the effective date of this rule, the sales price of all royalty oil from onshore and OCS leases will be the value determined under 30 CFR 206.102(c)(2), regardless of whether oil produced from the lease is or would be valued for royalty purposes on that basis. MMS will calculate and provide that value to the buyer. For royalty oil from OCS leases only, the price will include associated transportation costs to the designated delivery point, if applicable.

Proposed Rule: 30 CFR 206.102(c)(2)

If neither you nor your affiliate disposes of the oil under an arm's-length sales contract, use this paragraph (c) (2) to value the oil:

(i) For production from leases not in California or Alaska, value is the average of the daily NYMEX futures settle prices (Cushing, Oklahoma) for the Domestic Sweet crude oil contract for the prompt month. The prompt month is the earliest month for which futures are traded on the first day of the month of production. You must adjust the NYMEX prices for applicable location and quality differentials and you may adjust it for transportation costs under § 206.105(c) of this subpart.

(ii) For production from leases in California or Alaska, value is the average of the daily mean Alaska North Slope (ANS) spot prices for the month of production published in an MMS-approved publication (see paragraph (c) (4) of this section). You must adjust the spot prices for applicable location and quality differentials and you may adjust it for transportation costs under § 206.105(c) of this subpart.

Summary of comments received regarding: the oil valuation proposed rulemaking

The public comments that pertained to the proposed change to 30 CFR 208.4 (b) are summarized as follows:

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[1] See footnote 6, Chapter 2 for the definition of fair market value.

- Valuing RIK oil based on a NYMEX-driven formula would have the eligible refiners paying based on spot market prices despite the fact that the RIK contracts are long term. The MMS, in effect, would be receiving the highest prices throughout the life of the long-term contracts, a situation that is unheard of in the industry.

- The refiners, in addition to paying the highest possible prices under the proposed rule, would continue to incur additional costs to participate in the program (administrative fees and sureties).

- The eligible refiner RIK Program, if not eliminated in total, would be significantly scaled back because the price used for billing purposes would bear no relation to the market price. NYMEX averages generally are indicative of the refiners' incremental supply barrels, and are higher than the average refinery supply purchase.

- The proposal fails to take into account incremental costs incurred in getting the oil to the refinery (line loss, line transfer fees, MERC transactions, transportation, etc); there is inequity in the allowable pipeline cost deduction.

Commenters proposed the following alternatives for valuation of RIK oil:

- MMS should retain the current method of valuing RIK oil based on lease-by-lease gross proceeds.

- MMS should set a lease-by-lease price in the RIK contract based on actual transactions in the field.

- MMS should negotiate the values in each RIK sales contract with the eligible refiner rather than unilaterally dictating an external standard. The values could be based on whatever standard the parties agreed to accept.

However, in any pricing scenario, the refiners do not want to be subject to a lengthy audit period or to retroactive pricing liability.

The State of Wyoming also commented on the proposed rule, stating that it could support the addition of an index-based valuation method, but only in the case of true non arm's-length transactions. However, it stated that it has reservations about using NYMEX as the basis in Wyoming, because an independent's gross proceeds at the lease may be higher than NYMEX adjusted for transportation because of local supply and demand forces. In true arm's-length transactions, Wyoming favors the use of the gross proceeds valuation methodology. (Note--these comments pertain to in-value royalties, but are similar to the comments made by others concerning RIK valuation.)

APPENDIX B

Evaluation of Non-Selected Options

During the Minerals Management Service's (MMS) Oil RIK Study Team's review, several team members developed various options for billing/collecting for royalty oil under royalty-in-kind (RIK) contracts. The team analyzed each of these options and discussed them with refiners, lessees, and others. The team determined that several of the options presented problems that made them undesirable (see Chapter 3 of the team's report). The options that were not selected are described below.

Option 1
MMS Bills the Refiner from OGOR/3160

Reporting Responsibility

Under this option the lessee would cease reporting to MMS. No *Report of Sales and Royalty Remittance* (Form MMS-2014) would be required for RIK transactions. The operators would continue to report on the *Oil and Gas Operations Report* (OGOR) or *Monthly Report of Operations* (Form MMS-3160)[1]. The production volumes reported on the OGOR and Form MMS-3160 would be used to bill the RIK refiner. The value for billing purposes would be established on the principal of certainty (assuming the proposed oil valuation rulemaking or a comparable rulemaking is approved).

Billing Cycle

Production information on the OGOR/Form MMS-3160 is reported by the lease/agreement operator 45 to 55 days after the production month. The RIK volumes are reported as "sold" on both the OGOR and Form MMS-3160. This data is available through MMS's Production Accounting and Auditing System (PAAS), assuming the OGOR/Form MMS-3160 does not reject.

For hard copy reports, production volumes are reported on the 15th day of the second month following the production month (9/96 reported by 11/15/96), or 45 days after the production month. For electronic commerce reports, reporters have until the 25th of the second month following the production month to report, or 55 days after the production month.

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[1] These reports are used by operators to report monthly production information to MMS. The OGOR is used primarily for offshore leases and the Form MMS-3160 is used only for onshore leases.

For current in-kind transactions, the bill for royalty oil is generated about 45 days after the production month and payment is received about 60 days after the production month. This is necessitated because the bill is generated from the Form MMS-2014, which must be uploaded in MMS's Auditing and Financial System (AFS) in order to generate the bill. The Form MMS-2014 is received by the end of the month after the production month.

Should the bill be generated from the OGOR/Form MMS-3160, payment probably would be received about 90 days after the production month, depending on production report processing and bill generating requirements. The OGOR/Form MMS-3160 would be received about 55 days after the production month (for electronic commerce reports) and uploaded (accepted documents only) by about 60 days after the production month. The bills could then be generated and issued within about a 15 day window of time with payment required in another 15 days, or 90 days after the production month. Delays in billing would require additional surety or MMS would have to accept additional risk. This would also delay disbursement to the States of their revenue share by 30 days, unless the cash surety is increased.

Availability and Reliability of Information

A related consideration to the discussion of the billing cycle is the availability of oil sales information for billing purposes. The reliability of this information, in certain respects, is acceptable given the low reporting error rates. However, this only pertains to the operator reporter complying with the OGOR/Form MMS-3160 form reporting requirements. The OGOR is subjected to 222 edits, any one of which could result in a rejected line. The Form MMS-3160 is subjected to 95 such edits. For example, edit routines are used to ensure that the well being reported is associated with the correct lease or that the report of beginning inventory in a tank agrees with the previous month's report of ending inventory. All edits are executed during initial report processing. The average reporting error rate is currently less then 3 percent based on the number of lines reported and the number of lines rejected in the front end edit routines.

However, a report document cannot be uploaded in PAAS and accepted for subsequent processing including RIK bill generation until all lines on the report clear the front end edit routines. This occurs because an individual data line on the OGOR/Form MMS-3160 does not stand alone and is tied to other information on the report. In order for the OGOR/Form MMS-3160 to be usable, the lines must be linked together. This is unlike the Form MMS-2014 where all information associated with a transaction such as lease number, transaction code, product code, sales month, etc. is contained in the report line. Therefore, the total number of lines on the OGOR/Form MMS-3160 not available for processing and RIK bill generation are not only the lines rejected in the front end edit process but also the cleared lines on the documents containing rejected lines. The total number of lines unavailable for processing and billing purposes would therefore be greater than 3 percent.

An average of about 10 percent of OGOR documents and 15 percent of Form MMS-3160 documents received in a month are on hold and not processed awaiting correction of erroneously

reported data. In March 1997 MMS received a total of about 29,000 documents of which about 3,500 were in a hold status. The total number of lines included on these documents approximates 500,000, with an estimated 60,000 lines in a hold status. Some of these documents are on hold for 90 days or longer, but these are few in number. Most documents on hold are cleared within 60 days of receipt. In other words, sales information on the cleared lines would not be available for RIK billing purposes until the entire document (all lines) is cleared and processed. At the present time, no priorities are established for correcting rejected lines.

Another consideration in analyzing the availability of oil sales information pertains to operator adjustments. Accepted data is "reliable" but is often adjusted by the operator as needed. Typical adjustments are correction of volumes due to recalibration of meters, reallocation from system operators, or remeasuring of tanks. Adjustments to the OGOR/Form MMS-3160 are often voluminous, particularly for operators reporting on paper. The vast majority of adjustments pertain to Forms MMS-3160, which account for about 85 percent of all production reports received in a month. An estimated 30 to 40 percent of all originally reported lines on the OGOR/Form MMS-3160 are adjusted. The actual number of lines adjusted is less than the 30 to 40 percent figure since the entire document must be resubmitted by the operator to adjust even one line. This would affect the "accuracy" of the bill and the need for adjustments on succeeding bills. However, Form MMS-2014 adjustments are at the same level of magnitude so there is no discernable difference between document types as to their impact on RIK billing.

Zero Sales Reporting

In the current RIK accounting process, the Form MMS-2014 reporter is required to report zero sales on the Form MMS-2014 when that condition exists so that MMS can distinguish between receiving no report for the lease and zero sales on the lease. Leases in an RIK status are the only leases for which MMS requires zero sales reporting on the Form MMS-2014. This is necessary because a no-report condition may reflect a transaction missing from the report rather than the absence of any oil sales. The RIK bill includes estimates for leases when zero sales are not identified.

In contrast to the Form MMS-2014 reporting requirement described above, operators are required to report monthly on the OGOR/Form MMS-3160 each well from the time it is drilled to the time it is abandoned. Therefore, estimated billing amounts associated with unreported sales would no longer be necessary under this option. The disposition reporting on the OGOR/Form MMS-3160 would reflect zero sales.

Lease-Level versus Agreement-Level Reporting

The *Federal Oil and Gas Royalty Management Act of 1982* requires specific information be provided to States in an Explanation of Payments statement. Title 30 CFR 219.104 requires that

> "Payments to States . . . be described in *Explanation of Payment* reports prepared by MMS. These reports will be at the lease level and shall include a description of the type of payment being made, the period covered by the payment, the source of the payment, sales amounts upon which the payment is based, the royalty rate, and the unit value."

Such information is easily obtained by using the Form MMS-2014, as it is based on lease-level reporting. However, with OGOR's and Forms MMS-3160, lease level reporting is not required when a lease is in an agreement. Specifically, if the participating lease is part of a unit or participating area, production volumes related to that lease are reported on the OGOR/Form MMS-3160 at the agreement number level. There is no way currently to systematically allocate that production to a specific lease for (a) minimum royalty considerations, (b) identification of county level information for acquired lease distribution, or (c) provision of county level distribution information to distribute Mineral Leasing Act (public domain) royalty proceeds at that level.

Another complication pertaining to agreement level reporting is that in some cases a lease in a communitization agreement (CA) overlaps a participating area (PA) in a unitization agreement. Royalty volumes are reported to MMS on the OGOR/Form MMS-3160 for the CA. The volumes must then be manually reallocated to the PA. If the oil volumes are allocated among different parties (i.e., refiner for in kind, one or more lessees for in value) the allocation of volumes for the overlapping lease would be extremely difficult. In addition, the RIK bill may be based upon an incorrect allocation of volumes. Agreements where CA/PA overlapping occurs or county distribution problems exist could be excluded from the RIK program.

A third problem concerns the use of allocation percentages to allocate amounts in a PA or CA to a lease. The MMS relies upon the Bureau of Land Management to provide these factors but they are not always provided timely. Therefore, the allocation factors that would be used to allocate back to the lease may not be current and therefore correct. This would apply to the situation where a refiner receives deliveries from individual leases but the leases within the CA or PA are a combination of in kind and in value. The following possible solution, while not perfect, partially addresses this issue. This would be to require either one refiner or a combination of refiners to take all the oil. This approach would probably be more desirable by focusing on larger producing areas rather than single leases, many of which are marginal producers. However, it has limitations. For example, the volumes may be too large given refiner capacity for one refiner to take. While it may also be possible to split the PA or CA among two or more refiners, should one party exit the RIK program, a reallocation of volumes would be necessary and refinery capacity limitations with one or more remaining refiners may be a problem.

Accounting System Implications

The AFS and perhaps PAAS would require modification. The AFS would require modification to pull volumes from the OGOR/Form MMS-3160 rather than the Form MMS-2014 in generating

the RIK bill. Additional redesign would be necessary for statistical and informational reports. A system modification would be necessary to pick up RIK bill lines and post them to the Business Information System and other statistical reporting files instead of using Form MMS-2014 data. Currently, only the Form MMS-2014 is used and needed to post royalty data to the Business Information System. A system impact analysis needs to be done if this option is selected as the preferred option to further assess costs and benefits.

Designation of the Offshore Delivery Point

The operators and refiners at the March 26, 1997, meeting suggested that if the delivery point were at the offshore facility measurement point with a royalty meter (FMP) nearest the lease, delivery vs. entitlement imbalance problems should be minimized. Currently, the operator nominates RIK oil in the month preceding the production month. Nominations are based on estimates of production and, when production is different than expected, differences between delivered volumes (nominated volumes) and produced volumes (entitled volumes) occur. Such differences occur because of the need to schedule deliveries at delivery points off the lease. These differences should be minimized, according to the meeting participants, when the operator delivers the royalty share of the production at the lease.

Transportation and delivery requirements are discussed at 30 CFR 208.8. Offshore delivery requirements for Section 8 leases issued after September 1969 are that the oil be delivered by the lessee at a delivery point to be designated by MMS. For Section 6 leases and Section 8 leases issued before October 1969, the lessee shall deliver royalty oil at a delivery point to be designated by the lessee. A section 6 lease is an oil and gas lease originally issued by any State and currently maintained in effect pursuant to section 6 of the *Outer Continental Shelf Lands Act*. A Section 8 lease is an oil and gas lease originally issued by the United States pursuant to Section 8 of the *Outer Continental Shelf Lands Act*.

The FMP may or may not be on or immediately adjacent to the lease. Not all platforms in the Gulf of Mexico have approved royalty meters. The MMS office responsible for managing offshore oil and gas operations, Offshore Minerals Management (OMM), requires that a Lease Automated Custody Transfer (LACT) unit be at the FMP. Some platforms only have an allocation meter and do not satisfy the LACT unit requirement. Such a platform does not meet the FMP requirement and cannot be considered a delivery point. To require every platform to have a LACT unit would be costly as these units are expensive to install according to OMM. Consequently, some of the platforms would not be eligible as delivery points.

Transportation Costs Paid by Refiners

Were the platform to be designated as an FMP, some refiners could experience high transportation charges downstream of the platform in cases involving privately owned facilities such as private or lateral pipelines. Concerning the possibility of requiring the delivery point to be at the FMP wherever possible, the rates charged for transportation on lateral lines might vary

significantly depending on the producer and the refiner. This may serve as an economic disincentive to the refiner for participation in the RIK program.

For oil delivery made off the lease, the oil is often transported through a lateral pipeline, owned by the producer/operator (or other privately owned facility), to a delivery point at a common carrier trunk line. The MMS reimburses the producer/operator for "reasonable" transportation costs associated with the unregulated lateral pipeline and the actual common carrier pipeline costs incurred upstream of the delivery point. The lessee reports the transportation costs on the Form MMS-2014 using transaction code 11 (transportation allowance). This transportation cost is then recouped from the royalties paid on in-value offshore leases reported by the lessee on the Form MMS-2014. In cases where such deductions are not possible, MMS makes a wire payment for the transportation deduction amount to the lessee.

OCS lease terms (Form MMS-2005, March 1986) state:

> When paid in amount, such royalties shall be delivered at pipeline connections or in tanks provided by the Lessee. Such deliveries shall be made at reasonable times and intervals and, at the Lessor's option, shall be effected either (i) on or immediately adjacent to the leased area, without cost to the Lessor, or (ii) at a more convenient point closer to shore or on shore, in which event the Lessee shall be entitled to reimbursement for the reasonable cost of transporting the royalty substance to such delivery point.

While 30 CFR 208.8(c) does not address the issue of reasonable transportation costs, it does specify when the deliveries are to be made. It states:

> The lessee will make available and the purchaser will accept delivery of the royalty oil entitlement no later than the last day of the calendar month immediately following the calendar month in which the oil was produced.

Note: 208.8 (c) would have to be changed if MMS were to require continuous deliveries of its share of production.

The matter of reasonable transportation costs is addressed in 30 CFR 206.104, transportation allowances--general. Paragraph 206.104(a) states that:

> Where the value of oil has been determined pursuant to §206.102 of this subpart at a point (e.g., sales point or point of value determination) off the lease, MMS shall allow a deduction for the reasonable, actual costs incurred by the lessee to: . . . 2) Transport oil from an offshore lease to the point off the lease; provided, however, that for oil taken as RIK, a transportation allowance shall be provided for the reasonable actual costs incurred to transport that oil to the delivery point specified in the contract between the RIK oil purchaser and the Federal Government.

Again, these regulations only address transportation costs upstream of the delivery point. The regulations then proceed with a discussion of the requirements pertaining to the 50 percent transportation deduction, an allowance in excess of 50 percent, and other requirements pertaining to arm's-length and non-arm's-length or no contracts. In the case of transportation allowances in excess of 50 percent, the regulations at 30 CFR 206.104(b)2 state that:

> The lessee must demonstrate that the transportation costs incurred in excess of the limitation . . . were reasonable, actual, and necessary. An application for exception . . . shall contain all relevant and supporting documentation necessary for MMS to make a determination. Under no circumstances shall the value, for royalty purposes, under any selling arrangement, be reduced to zero.

The pros and cons associated with this option are as follows:

Pros

1. Eliminates Form MMS-2014 reporting by lessees.

2. Refiners and operators state that the number of adjustments regarding oil taken at OCS platforms are small where the production is metered at the platform facility measurement point.

3. Refiners and operators indicate that moving the delivery point to a location at or near the lease would resolve many delivery balancing problems currently encountered where the delivery point for offshore leases is at an onshore location.

Cons

1. The RIK billing cycle would be extended an additional 30 days.

2. Additional billing adjustments probably would be necessary since the OGOR/Form MMS-3160 document is not available to PAAS until all lines on the document are cleared.

3. Does not solve the issue of entitled vs. delivered volumes.

4. Requires MMS to calculate royalty volumes based on OGOR/Form MMS-3160 volumes and prepare Forms MMS-2014 to allocate the volumes to individual Accounting Identification Numbers (lease plus revenue source) and generate RIK bills.

5. Requires significant system redesign to pull volumes from the OGOR/Form MMS-3160 for billing purposes.

Option 2
Lessee Reports Based on Deliveries

Currently, lessees report entitled royalty quantities and values on the Form MMS-2014. The information is reported by the lessees at the same time as they would report in value, i.e., at the end of the month following the month of production. The information is processed by AFS and reformatted onto RIK bills within 2 weeks of receipt (or 45 days after the month of production). The reporting is required by regulation. The reported data is subject to audit and adjustment.

Under this option, lessees would continue to report on the Form MMS-2014. However, the actual volume delivered to the refiner (the royalty share of production as it passes through the royalty meter at the FMP) would be reported rather than lease entitlement. The MMS would bill refiners for delivered volumes based on the Form MMS-2014. Imbalances between entitlements and deliveries would be identified by the AFS/PAAS comparison. During the contract, imbalances would be resolved in kind. After termination of the contract, any under deliveries would be made up in value.

Currently, the operator nominates RIK oil in the month preceding the production month. Because of the need to schedule deliveries at delivery points off the lease, nominations are based on estimates of production and, when production is different than expected, differences between nominated volumes and entitled volumes occur. These differences should be minimized when the operator delivers the royalty share of the production at or near the lease. However, where the delivery point is not at or near the lease, the lessee's administrative burden would be increased because of having to obtain information to report delivered volumes on the Form MMS-2104. This probably would cause a delay in filing the Form MMS-2014 with MMS.

Actions regarding designation of the offshore delivery point as presented in Option 1 are also implemented in this option.

The pros and cons associated with this option are as follows:

<u>Pros</u>

1. Enables MMS to know and bill the actual delivered volumes, thereby charging the refiners only for the oil they actually receive.

2. Gives MMS delivery information and a continuing source of information to determine whether the lease royalty entitlement has been received by the Government.

<u>Cons</u>

1. Requires lessees to continue reporting on the Form MMS-2014, along with the attendant administrative costs.

2. Does not improve the RIK billing cycle.

3. Lessees would not know delivery information when the RIK delivery point is other than an approved royalty meter at an FMP. This option would require them to obtain additional information for these delivery points that allocates the volumes by production source.

4. May result in a delay in revenue receipts.

Option 3
Refiner Reports and Pays Based on Entitlements

Under this option the refiner would report and pay, via the Form MMS-2014, for entitled volumes. The lessee would report the entitled volumes to the refiner who would, in turn, report these volumes to MMS. The value for reporting and paying purposes would be established on the principal of certainty (assuming the proposed oil valuation rulemaking or a comparable rulemaking is approved).

This option would become viable only if the refiner receives entitlement information from the lessee.

Administrative burden would be increased since this information would need to be reported to the refiner by the lessee. Consequently, this approach would involve additional paperwork.

Actions regarding designation of the offshore delivery point as presented in Option 1 are also included in this option.

The pros and cons associated with this option are as follows:

Pros

1. Lessee does not report to MMS on the Form MMS-2014.

2. The refiners may know the entitled volumes 2 weeks sooner than they do now.

Cons

1. Lessee would need to report entitlement information to refiner, thus retaining its administrative costs.

2. Refiner would report the entitlement information to MMS. Instead of streamlining a process, another step and party would be added to the administration of the program.

Option 4
Status Quo with Delivery Point at or near the Lease

Lessees would continue to report royalty quantities and values on the Form MMS-2014. (Note: value information may not need to be reported should MMS establish values for RIK oil.) The information reported by the lessees is provided at the same time as they would report in value, i.e., at the end of the month following the production month. The information is processed by AFS and reformatted onto RIK bills within 2 weeks of receipt (about 45 days after the production month). The bills are paid by 60 days following the production month.

If the methodology for determining value is changed, a modification to the AFS may be necessary in order to generate the RIK bills. It would then be necessary that modifications be made to maintain the integrity of the financial data base (the royalty Detail Financial Transaction File) and the various files upon which it is based, such as the Royalty Query System and the Business Information System. This data base has historically represented a picture of what was reported and accepted into the system and not anything calculated by MMS.

Operators continue to report production quantities on the OGOR/Form MMS-3160. Production volumes are reported on the 15th day of the second month following the month of production (9/96 reported by 11/15/96), 45 days after the production month, except that automated reporters have until the 25th of the month, 55 days after the production month. The RIK volumes are reported as "sold" on both the Form MMS-3160 and OGOR. The information is processed by PAAS and is available for reconciliation. Current AFS/PAAS comparisons are performed 6 months following the production month. The RIK Section manually reconciles Form MMS-2014 quantities with OGOR/Form MMS-3160 quantities.

Actions regarding designation of the offshore delivery point as presented in Option 1 are also included in this option. The pros and cons associated with this option are as follows:

Pros

1. Achieves some improvement in the oil RIK program by eliminating some of the delivery balancing problems.

2. System modification may not be necessary, depending on the valuation methodology.

Cons

1. Does not meet the goals of simplifying reporting and reducing administrative burden.

2. Lessee continues to report entitlements to MMS on the Form MMS-2014 and refiner continues to be billed based on entitlements and pay for volumes not received.

APPENDIX C

Royalty-In-Kind Deliveries and Volume Imbalances

Some of the refiners participating in the current oil Royalty-In-Kind program (RIK) have complained that they often are billed for royalty oil that they do not receive until much later, if at all. Some of these discrepancies are caused by the billing process, while others are caused by the delivery process.

The problems that can be identified to the billing process are those involving estimated billings. These usually are caused when a lessee does not report on an active RIK selling arrangement (SA). When this occurs, the Auditing and Financial System generates an estimated volume and value for that SA based on historical amounts or on an amount estimated prior to the contract. The estimated amount is entered on the bill with a non respondent code (NR), and is therefore part of the overall billing for that month. If the lessee later reports on the SA for a month in which an NR was billed, the NR amount is credited on the next bill and the actual entitled amount is billed.

However, if the lessee does not subsequently report an actual amount for the SA, the NR is not reversed until a reconciliation shows that it is an erroneous billing. The lessee's failure to report can be caused by several things, including zero sales for the month (although the lessee is supposed to report zero sales on RIK SA's) or invalid selling arrangements that have not been properly end-dated. Whatever the reason, the refiner that has been billed an erroneous NR loses the use of the billed and paid amount until the reconciliation occurs.

The problems that are attributable to the delivery process usually occur on offshore leases where the delivery point is away from the lease. Rather than being required to deliver the royalty oil as it flows through the royalty meter at the facility measurement point (FMP), the lessee arranges to deliver the oil at the designated delivery point downstream. The lessee nominates the volumes to be delivered at the delivery point the month prior to the month of production, based on its estimates of production. The amounts are delivered at agreed times and intervals, but are not adjusted to reflect production fluctuations. Therefore, there are volume variances virtually every month, some of which can be significant. However, the lessees report royalty entitlements on the *Report of Sales and Royalty Remittance* (Form MMS-2014), and the refiners pay these amounts. Because the deliveries are estimates, the variances between royalty entitlements and deliveries are ever present. (See example below.)

The preferred option discussed in Chapter 3 of Minerals Management Service's (MMS) Oil RIK Study Team report would eliminate the problems associated with the billing process because the refiner would not be subject to the vagaries associated with estimated deliveries accompanied by NR billings. The refiner would be receiving and paying for actual allocated volumes, not

estimates. Furthermore, the allocated volumes should approximate entitlements because the volumes would be allocated to the refiners as production flows through the FMP.

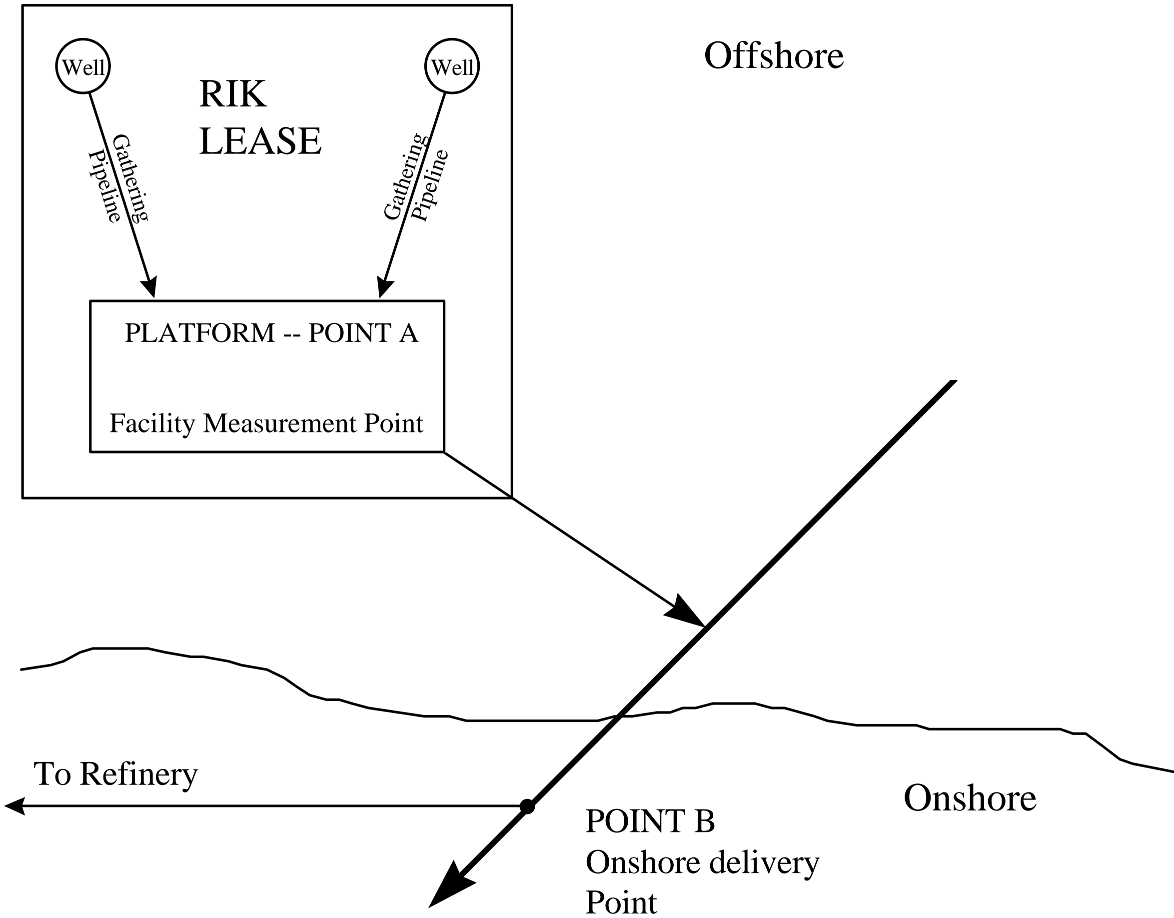
The following is a simple example of the difference between current oil RIK program practice and the preferred option method on an offshore lease:

Under the current program, MMS directs the lessee to deliver the royalty oil to the refiner at Point B, an onshore pipeline interconnect (see diagram below). In the month preceding the production month, the lessee estimates that production will be 36,000 barrels for the month. Therefore, he informs the refiner that he will deliver the royalty share (6,000 barrels) to the refiner at Point B at designated times.

However, the month's actual production is 42,000 barrels, and the related royalty share is 7,000 barrels. The lessees report the entitled volumes on their Forms MMS-2014, and these amounts are reflected on the invoice that MMS sends to the refiner. Therefore, the refiner is bound, under contract, to pay for 7,000 barrels of royalty oil for the month, even though only 6,000 barrels were delivered. In addition, if a lessee fails to report on an active SA, the refiner is billed additional volumes, as discussed above. The lessee eventually will make up the volume shortage, the lessee will correct the reporting, or a reconciliation will disclose the discrepancy, but it may take a while. In the meantime, more overs and shorts are created every month.

Under the preferred option, MMS will direct the lessee to deliver the royalty oil to the refiner at Point A, the FMP, as it flows through the royalty meter. The delivered volumes will be determined by a pre-set allocation percentage at the meter, not by an earlier estimate. In other words, if the delivery point is for one lease with a one-sixth royalty share, the delivery point operator will be instructed to deliver the one-sixth share to the refiner at the metering point as the oil flows through the meter. The refiner, therefore, will receive and pay for the 7,000 barrel royalty share of production.

This continuous delivery process should dramatically reduce the number and size of volume discrepancies, saving money for the refiners and administrative burdens for MMS and industry. Also, because the refiner will be reporting and paying instead of the lessees, the problems associated with lessee non reporting will be eliminated.



RIK Contract Delivery Points

APPENDIX D

Proposed Oil RIK Procedure and Industry Comments

Following the May 20, 1997, meeting with refiners, lessees, and operators, the study team prepared a proposed oil royalty-in-kind (RIK) procedure and circulated it among the meeting participants for comment. The draft procedure and comments are included in this Appendix as follows:

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Comments	
Chevron Production Company	42
Council of Petroleum Accountants Societies	50
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MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM

PROPOSED OIL ROYALTY-IN-KIND PROCEDURE

In most cases, the lessees will deliver the royalty share of oil production from or attributable to a lease (royalty oil) to the purchasing refiner at a designated delivery point on or near the lease[1]. Title to the royalty oil will transfer to the refiner at the delivery point. The refiner must accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The refiner will be responsible for all downstream transportation, costs, and disposition of the oil, and will assume all associated risks.[2]

The lessee will notify the refiner of the estimated volume of royalty oil that will be available for delivery in accordance with its normal notification procedures in the month preceding the month of delivery. The lessee also will communicate to the refiner any circumstances other than routine production fluctuations that will affect royalty oil deliveries from the lease during the production month so that the refiner may adjust its transportation and marketing arrangements.

The lessee will instruct the delivery point operator to deliver the royalty oil to the account of the refiner at the designated point of delivery. The refiner will make all nominations and other arrangements downstream of the delivery point and will settle all downstream imbalances.

The lease operator will notify the refiner not later than --- days prior to the end of the month following the month of production of the volumes that were allocated to the refiner's account. The notification will list the volumes by property.[3] Based on this information, the refiner will report to MMS on a Form MMS-2014, *Report of Sales and Royalty Remittance* (2014), its

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[1] For offshore leases, the delivery point normally will be an offshore Facility Measurement Point that has been designated a Royalty Determination Point by Offshore Minerals Management, MMS. For onshore leases, the delivery point will be on or adjacent to the lease pursuant to the terms of the lease.

[2] Although the intent is to take most royalty oil as close to the lease as possible, MMS reserves the right to designate an onshore or other delivery point at any time. If the designated delivery point is on or near the lease, the lessee will deliver the royalty oil without cost to the federal government as an undivided share of production in marketable condition at pipeline connections or other facilities provided by the lessee, unless other arrangements are approved by MMS. If the delivery point is not on or near the lease, MMS will reimburse the lessee for the reasonable cost of transportation to such point.

[3] In other words, the volumes allocated to lease basis wells, unit agreements, etc., will be separately identified.

allocated volumes by lease and revenue source number.[4] The refiner also will calculate the value of the royalty oil[5], enter the value on the 2014, and remit payment to MMS. The refiner will report and pay via electronic commerce by the end of the month following the month of production. The lessee no longer will report on the 2014 for royalty oil taken in kind; however, the operators will continue to submit production reports.

The MMS will continue to perform AFS/PAAS comparisons, but will begin to compare information as soon as the production data are available in MMS's automated system. The MMS will work with the lease operator and/or lessee to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated. The lessee will settle volume discrepancies in kind during the term of the contract.

When balancing volumes are delivered in kind, the refiner will report a separate line on the 2014 showing the month to which the adjusted volumes relate, and will pay for the adjusted volumes at the price specified by regulation.[6] If the contract is no longer in effect, the lessee will be required to settle imbalances in value, at the price established by regulation for royalty oil taken in kind.

For the refiner: The RIK contract will specify reporting and paying requirements which, if not followed, may result assessment of interest or penalties or in contract termination. Refiner reports and substantiating records will be available for audit by MMS. For the lessee: Penalties will be assessed for failure to comply with lease terms (for example, failure to deliver royalty oil).

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[4] The MMS will provide model Forms MMS-2014 and training in their use.

[5] The pricing formula for royalty oil purchased by a refiner under this program will be established in the contract. The formula to be used has not yet been established, but is being developed in conjunction with MMS's proposed oil valuation rule.

[6] In other words, adjusting volumes for the month of January that are delivered in April would be reported on the 2014 submitted in May as a separate line item, identified as January deliveries.

CHEVRON FACSIMILE MESSAGE

CHEVRON LAW DEPARTMENT
1301 MCKINNEY STREET
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FACSIMILE NO. (713) 754-3366

FAX COVER SHEET

DATE: 06/20/97 TIME: 12:51 PM

TO Vern Ingram (303) 231-3508
Jim McNamee (303) 275-7124

FROM

George W. Butler, III
Chevron Law Department
P.O. Box 3725
Houston, TX 77253-3725
Telephone (713) 754-7809

Number of Pages (Including Cover) 8

Attached are Chevron's suggested changes, plus a redline version comparing Chevron's version to MMS' original draft of the option. Thanks for allowing us the opportunity to comment.

As we stated in May in Boulder, Chevron would like to participate in an oil RIK pilot.

If you do not receive all pages, please phone: Sherri Fallin, (713) 754-3444.

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM

PROPOSED OIL ROYALTY-IN-KIND PROCEDURE

The lessee will deliver the royalty share of oil production from or attributable to a lease (royalty oil) at or near the lease (unless the lease expressly provides for delivery at a different location).[1] Title to the royalty oil will transfer to the purchaser at the delivery point. The purchaser must accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The purchaser will be responsible for all downstream transportation, costs, and disposition of the oil, and will assume all associated risks.[2] The lessee's royalty obligation will be satisfied as to any royalty oil delivered to the purchaser at the delivery point.[3] Delivery of royalty in kind by the lessee shall satisfy in full the lessee's royalty obligation. Once the oil is delivered, the lessee shall not be subject to reporting and record-keeping requirements for its working interest share of oil production.

The lessee will notify the purchaser of the estimated volume of royalty oil that will be available for delivery in accordance with its normal notification

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[1] For offshore leases, the delivery point will be the Facility Measurement Point designated by Offshore Minerals Management, MMS, as the point of royalty settlement. For onshore leases, the delivery point will be the point of volume measurement at or near the lease unless the lease expressly provides otherwise.

[2] If the designated delivery point is at or near the lease, the lessee will deliver the royalty oil without cost to the federal government as an undivided share of production. If the delivery point is not at or near the lease (pursuant to lease terms), MMS will reimburse the lessee for the reasonable cost of transportation to such point. If the delivery point is not at or near the lease, MMS recognizes that quality at the royalty settlement point (FMP) may differ from quality at the delivery point. Quality differences which are not resolved by means of quality banks will be settled in cash at regular intervals, e.g., monthly or quarterly. This RIK procedure and all RIK contracts with eligible purchasers will specify that failure by a lessee or purchaser to cash out a quality difference constitutes failure to perform with MMS.

[3] The MMS still has the right to audit the lessee in order to determine whether the correct quantity of royalty oil was delivered to the purchaser at the designated deliver point.

procedures in the month preceding the month of delivery. The lessee also will communicate to the purchaser any circumstances other than routine production fluctuations that will affect royalty oil deliveries from the lease during the production month so that the purchaser may adjust its transportation and marketing arrangements.

The lessee will instruct the delivery point operator to deliver the royalty oil to the account of the purchaser at the designated delivery point. The purchaser will make all nominations and other arrangements downstream of the delivery point and will settle all downstream imbalances.

The lease operator will notify the purchaser not later than _____ days prior to the end of the month following the month of production of the volumes that were allocated to the purchaser's account. The notification will list the volumes by property.[4] Based on this information, the purchaser will report to MMS on a Form MMS-2014, *Report of Sales and Royalty Remittance* (2014), its allocated volumes by lease and revenue source number.[5] The purchaser also will calculate the value of the royalty oil[6], enter the value on the 2014, and remit payment to MMS. The purchaser will report and pay via electronic commerce by the end of the month following the month of production. The lessee no longer will report on the 2014 for royalty oil taken in kind; however, the operators will continue to submit production reports.

The MMS may continue to perform AFS/PAAS volume comparisons, but will begin to compare information as soon as the production data are available in

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[4] In other words, the volumes allocated to lease basis wells, unit agreements, etc., will be separately identified.

[5] The MMS will provided model Forms MMS-2014 and training in their use. The quantity and quality measured at the delivery point will be appropriate for royalty purposes only if the delivery point is also the Facility Measurement Point. If the two are different, the purchaser must be notified of the quantity and quality at the delivery point and the Facility Measurement Point.

[6] The pricing formula for royalty oil purchased by a purchaser under this program will be established in the contract. The formula to be used has not yet been established, but is being developed in conjunction with MMS' proposed oil valuation rule.

MMS's automated system. The MMS will work with the lease operator and/or lessee to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated. The lessee and purchaser will settle volume discrepancies in kind during the term of the contract.

When balancing volumes are delivered in kind, the purchaser will report a separate line on the 2014 showing the month to which the adjusted volumes relate, and will pay for the adjusted volumes at the price specified by regulation.[7] If the contract is no longer in effect, the lessee and purchaser will be required to settle imbalances in value, at the price established by regulation for royalty oil taken in kind.

For the purchaser: The RIK contract will specify reporting and paying requirements which, if not followed, may result in assessment of interest or penalties or in contract termination. Purchaser reports and substantiating records will be available for audit by MMS. For the lessee: Any interest and/or penalties for the lessee's failure to satisfy its RIK obligations will be assessed in accordance with lease terms, statutes and regulations.

MMS recognizes that eligible purchasers are not in a contractual relationship with lessees and/or operators. Rather, each is in a separate contractual relationship with MMS. If a problem arises between a lessee/operator and a purchaser, (e.g., information requirements, quality differences, volume imbalances, etc.), MMS will not establish procedures which merely require that lessees and purchasers settle differences among themselves.[8]

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[7] In other words, adjusting volumes for the month of January that are delivered in April would be reported on the 2014 submitted in May as a separate line item, identified as January deliveries.

[8] For example, 30 CFR 208.8(b) currently states, "...quality differentials between the royalty oil to which a purchaser is entitled and the oil which is made available at the delivery point are matters to be resolved between the purchaser and the operator." This results in numerous inequities. If MMS designates a delivery point downstream of the Facility Measurement Point where production quantity and quality are measured for royalty purposes, then regulations, procedures and the RIK contract must specify the means by which essential information is transmitted to the party with reporting responsibility. In addition, a means to settle quality differences must be specified.

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM

PROPOSED OIL ROYALTY-IN-KIND PROCEDURE

~~In most cases, the lessees~~The lessee will deliver the royalty share of oil production from or attributable to a lease (royalty oil) ~~to the purchasing refiner at a designated delivery point on or near the lease~~at or near the lease (unless the lease expressly provides for delivery at a different location).[1] Title to the royalty oil will transfer to the ~~refin~~purchaser at the delivery point. The ~~refin~~purchaser must accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The ~~refin~~purchaser will be responsible for all downstream transportation, costs, and disposition of the oil, and will assume all associated risks.[2] The lessee's royalty obligation will be satisfied as to any royalty oil delivered to the purchaser at the delivery point.[3] Delivery of royalty in kind by the lessee shall satisfy in full the lessee's royalty obligation. Once the oil is

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[1] For offshore leases, the delivery point ~~normally~~ will be ~~an offshore~~the Facility Measurement Point ~~that has been~~ designated ~~a Royalty Determination Point~~ by Offshore Minerals Management, MMS, as the point of royalty settlement. For onshore leases, the delivery point will be ~~on or adjacent to the lease pursuant to the terms of the lease.~~

the point of volume measurement at or near the lease unless the lease expressly provides otherwise.

[2] ~~Although the intent is to take most royalty oil as close to the lease as possible, MMS reserves the right to designate an onshore or other delivery point at any time.~~ If the designated delivery point is ~~on~~at or near the lease, the lessee will deliver the royalty oil without cost to the federal government as an undivided share of ~~production in marketable condition at pipeline connections or other facilities provided by the lessee, unless other arrangements are approved by MMS.~~ production. If the delivery point is not ~~on or near the lease~~at or near the lease (pursuant to lease terms), MMS will reimburse the lessee for the reasonable cost of transportation to such point. If the delivery point is not at or near the lease, MMS recognizes that quality at the royalty settlement point (FMP) may differ from quality at the delivery point. Quality differences which are not resolved by means of quality banks will be settled in cash at regular intervals, e.g., monthly or quarterly. This RIK procedure and all RIK contracts with eligible purchasers will specify that failure by a lessee or purchaser to cash out a quality difference constitutes failure to perform with MMS.

[3] The MMS still has the right to audit the lessee in order to determine whether the correct quantity of royalty oil was delivered to the purchaser at the designated deliver point.

delivered, the lessee shall not be subject to reporting and record-keeping requirements for its working interest share of oil production.

The lessee will notify the ~~refin~~purchaser of the estimated volume of royalty oil that will be available for delivery in accordance with its normal notification procedures in the month preceding the month of delivery. The lessee also will communicate to the ~~refin~~purchaser any circumstances other than routine production fluctuations that will affect royalty oil deliveries from the lease during the production month so that the ~~refin~~purchaser may adjust its transportation and marketing arrangements.

The lessee will instruct the delivery point operator to deliver the royalty oil to the account of the ~~refiner at the designated point of delivery. The refin~~purchaser at the designated delivery point. The purchaser will make all nominations and other arrangements downstream of the delivery point and will settle all downstream imbalances.

The lease operator will notify the ~~refin~~purchaser not later than _____ days prior to the end of the month following the month of production of the volumes that were allocated to the ~~refin~~purchaser's account. The notification will list the volumes by property.[4] Based on this information, the ~~refin~~purchaser will report to MMS on a Form ~~MMS~~ MMS-2014, *Report of Sales and Royalty Remittance* (2014), its allocated volumes by lease and revenue source number.[5] The ~~refin~~purchaser also will calculate the value of the royalty oil[6], enter the value on the 2014, and remit payment to MMS. The ~~refin~~purchaser will report and pay via

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[4] In other words, the volumes allocated to lease basis wells, unit agreements, etc., will be separately identified.

[5] The MMS will provided model Forms MMS-2014 and training in their use. The quantity and quality measured at the delivery point will be appropriate for royalty purposes only if the delivery point is also the Facility Measurement Point. If the two are different, the purchaser must be notified of the quantity and quality at the delivery point and the Facility Measurement Point.

[6] The pricing formula for royalty oil purchased by a ~~refin~~purchaser under this program will be established in the contract. The formula to be used has not yet been established, but is being developed in conjunction with MMS's proposed oil valuation rule.

electronic commerce by the end of the month following the month of production. The lessee no longer will report on the 2014 for royalty oil taken in kind; however, the operators will continue to submit production reports.

The MMS ~~will~~may continue to perform AFS/PAAS volume comparisons, but will begin to compare information as soon as the production data are available in MMS's automated system. The MMS will work with the lease operator and/or lessee to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated. The lessee and purchaser will settle volume discrepancies in kind during the term of the contract.

When balancing volumes are delivered in kind, the ~~refin~~purchaser will report a separate line on the 2014 showing the month to which the adjusted volumes relate, and will pay for the adjusted volumes at the price specified by regulation.[7] If the contract is no longer in effect, the lessee and purchaser will be required to settle imbalances in value, at the price established by regulation for royalty oil taken in kind.

For the ~~refin~~purchaser: The RIK contract will specify reporting and paying requirements which, if not followed, may result in assessment of interest or penalties or in contract termination. ~~Refin~~Purchaser reports and substantiating records will be available for audit by MMS. For the lessee: ~~Penalties will be assessed for failure to comply~~ Any interest and/or penalties for the lessee's failure to satisfy its RIK obligations will be assessed in accordance with lease terms, statutes and regulations.
~~with lease terms (for example, failure to deliver royalty oil).~~

MMS recognizes that eligible purchasers are not in a contractual relationship with lessees and/or operators. Rather, each is in a separate contractual relationship with MMS. If a problem arises between a lessee/operator and a purchaser, (e.g., information requirements, quality differences, volume imbalances, etc.), MMS will not establish procedures which merely require that lessees and purchasers settle differences among themselves.[8]

[7] In other words, adjusting volumes for the month of January that are delivered in April would be reported on the 2014 submitted in May as a separate line item, identified as January deliveries.

[8] For example, 30 CFR 208.8(b) currently states, "...quality differentials between the royalty oil to which a purchaser is entitled and the oil which is made available at the delivery point are matters to be resolved between the purchaser and the operator." This results in numerous inequities. If MMS designates a delivery point downstream of the Facility Measurement Point where production quantity and quality are measured for royalty purposes, then regulations, procedures and the RIK contract must specify the means by which essential information is transmitted to the party with reporting responsibility. In addition, a means to settle quality differences must be specified.

Acadiana
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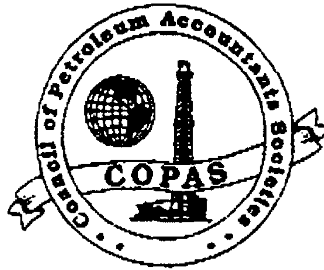

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Oklahoma City
Oklahoma-Tulsa
Permian Basin
Rocky Mountains
San Antonio
San Francisco
San Joaquin
West Central Texas
Wichita Falls

June 19, 1997

Mr. Vern Ingraham
Chief, Accounting and Reports Division
Minerals Management Service
Royalty Management Program
P O Box 25165 MS3130
Denver CO 80225-0165

RE: Proposed Oil Royalty-In-Kind Procedure

Dear Mr. Ingraham:

The Council of Petroleum Accountant's Societies (COPAS) appreciates the opportunity to provide comments to the June 13, 1997, proposal related to the small refiner royalty-in-kind procedure.

Overall, COPAS believes the procedure is very workable. We also believe that the procedure will reduce the lessees administrative burden, both from a marketing and an accounting standpoint.

COPAS' specific comments to the proposal are as follows:

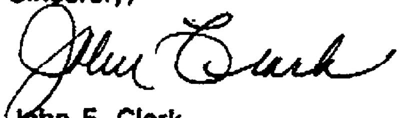
- Fourth paragraph - "The lease operator will notify the refiner not later than _____ days...". COPAS believes that 15 days would be sufficient in the majority of situations.
- Footnote 2, last sentence - "... MMS will reimburse the lessee for the reasonable cost ...". COPAS believes the word "reasonable" should be changed to "actual".
- Sixth paragraph - "when balancing volumes are delivered in kind ...". COPAS believes this should be changed to read "when volumes are adjusted ...". We believe Footnote 6 explains this situation, but the language should be changed for clarity. Because the refiner is paying on the allocated volume, balancing can occur and no additional reporting would be required.

Minerals Management Service
Mr. Vern Ingraham
Page 2
June 19, 1997

- Sixth paragraph - "If the contract is no longer in effect, the lessee will be required to settle imbalances in value, at the price established by regulation...". COPAS recommends that the price requirement of this sentence be changed to read "... at the price the lessee received ...".

Again, we thank MMS for the opportunity to comment on the procedure. If you have any questions, please contact John Clark at (405) 767-5044.

Sincerely,



John E. Clark
Chairman, COPAS Federal Affairs Subcommittee

lt

cc:
COPAS Federal Affairs Subcommittee

jec\ingraham.wp

EXXON COMPANY, U.S.A.
POST OFFICE BOX 2024 • HOUSTON, TEXAS 77252-2024

CONTROLLER'S DEPARTMENT
OWNERSHIP & ROYALTY

W. L. STONE
REGULATORY AFFAIRS ADVISOR

June 20, 1997

Mr. Vern Ingraham, Chief
Accounting and Reports Division
Minerals Management Services
PO Box 25165
Mail Stop 3130
Denver, CO 80225

BY FACSIMILE 303/231-3508

PROPOSED OIL ROYALTY-IN-KIND
PROCEDURE FOR SMALL REFINERS

Dear Mr. Ingraham:

Exxon Company U.S.A. ("Exxon"), a division of Exxon Corporation, submits these comments in response to your request of June 13, 1997 concerning the Proposed Oil Royalty-in-Kind Procedure for Small Refiners [proposal]. Exxon has substantial oil and gas production from its Federal leases and consequently has an interest in commenting on the proposal. To that purpose we provide comments basically covering two attributes of the proposal: I. Delivery Point and II. Production Information to be Provided to the Refiner.

I. Delivery Point

The proposal provides that the lessee "will deliver the royalty share of oil production from or attributable to a lease to the purchasing refiner at a designated delivery point on or near the lease." The proposal further provides that for offshore leases the delivery point "normally will be an offshore Facility Measurement Point that has been designated a Royalty Determination point by Offshore Minerals Management, MMS."

Unless the lessee is allowed to deliver the oil at the lease for all onshore and offshore leases, the current problems that have been experienced with nominations and over deliveries to small refiners will not be corrected. This is because the Facility Measurement Points designated for offshore leases are points away from the lease and in some cases are onshore locations. Nominations and resulting delivery imbalances will occur and the lessee will have to balance over and under deliveries with the small refiner. Because the lessee does not have contracts will the small refiners or any surety protecting the transactions, the lessee may be injured if the small refiner goes bankrupt or if the small refiner's contract with the MMS expires while the lessee is out of balance.

If the MMS would designate the lease as the delivery point in all instances, lessees could treat the MMS like any other take-in-kind working interest owner in the lease. The lessee would not be adversely affected by not having a contract or surety with the small refiner. The lessee's obligations would be with the MMS to deliver in-kind crude oil at the lease to the MMS as required by the lease. Once delivery is made, the lessee's lease obligations to the MMS would be satisfied.

II. Production Information to be Provided to the Refiner

The proposal states:

> ***The lease operator will notify the refiner not later than ___ days prior to the end of the month following the month of production of the volumes that were allocated to the refiner's account. The notification will list the volumes by property.***

Exxon suggests that the number of days be ten (10) prior to the end of the month following the month of production in order to provide sufficient time for the lease operator to accurately provide this information to the refiner on a lease basis as required.

In conclusion, we appreciate the opportunity to provide comments on the subject proposal.

Sincerely,

William L. Stone

WLS/SKT

cc: Mr. Jim McNamee, MMS (FAX – 303/275-7124)

June 19, 1997

FAXED TO: 303/275-7124

Mr. Jim McNamee
Minerals Management Service

Dear Jim,

Thank you for your recent fax. I appreciate your efforts in making the RIK program more commercially efficient.

The following are my comments on the "Proposed Oil Royalty-in-Kind Procedure":

Paragraph #2: Rather than state that the lessee can notify the refiner of projected volumes in accordance with its normal notification procedures, please consider requiring the lessee to report projected volumes by the 17th of the month preceding production. This would set a reasonable firm deadline and help those lessees who are not normally involved in the scheduling procedure.

Paragraph #4: I believe it should be the FMP operator, not the lessee, who should notify the refiner of actual volumes allocated to its account. I would require the FMP to complete such notification by the 10th day of the month following production.

Paragraph #6: Regarding balancing problems, I believe the refiner should pay for the oil based on prices in the month the oil was actually received. This proposal should help minimize any large imbalances, thus allowing the MMS to be comfortable in allowing the small refiner to simply pay for crude oil based on the month in which it was received.

General Comment on 2014 Reporting: As discussed in the meeting, it is our assumption that the volumes will be based on well detail provided by the pipelines or platform operators and lease allocations provided by the MMS. If a lease allocation is not provided in a timely, accurate manner by the MMS to the refiner, the refiner should not be held accountable for misallocations.

Thanks again, Jim, for your efforts in this area.

Sincerely yours,

GARY-WILLIAMS ENERGY CORPORATION

Donald A. Hamilton
Vice President
Raw Material Supply

DAH/aee

Republic Plaza • 370 17th Street • Suite 5300 • Denver, Colorado 80202-5653 • (303) 628-3800

23733 N. Scottsdale Road
Scottsdale, AZ 85255

FAX MESSAGE

To: Vera Ingraham

Firm::

Fax #: 303-231-3508

From: Luke Withers

Phone #: (602) 585-8829

Fax #: (602) 585-8894

Number of pages: 3 (including cover)

If you do not receive all of the pages, please inform Anne Elick as soon as possible at (602) 585-8805.

Date: 6-24-97

Time: 2:10

Re: MMS

MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM

PROPOSED OIL ROYALTY-IN-KIND PROCEDURE

In most cases, the lessees will deliver the royalty share of oil production from or attributable to a lease (royalty oil) to the purchasing refiner at a designated delivery point on or near the lease[1]. Title to the royalty oil will transfer to the refiner at the delivery point. The refiner must accept delivery of 100 percent of the royalty oil made available at the point of delivery by the lessee. The refiner will be responsible for all downstream transportation, costs, and disposition of the oil, and will assume all associated risks.[2]

The lessee will notify the refiner of the estimated volume of royalty oil that will be available for delivery in accordance with its normal notification procedures ~~in the month~~ by the 20th of the month preceding the month of delivery. At the same time ~~T~~the lessee also will communicate to the refiner any circumstances other than routine production fluctuations that will affect royalty oil deliveries from the lease during the production month so that the refiner may adjust its transportation and marketing arrangements.

The lessee will instruct the delivery point operator to deliver the royalty oil to the account of the refiner at the designated point of delivery. The refiner will make all nominations and other arrangements downstream of the delivery point and will settle all downstream imbalances.

The lease operator will: A. Instruct the FMP operator and transporter to provide copies of all documentation for volume determination (i.e., run tickets, allocation statements, pipeline statements, etc.); and, B. notify the refiner of the volumes that were allocated to the refiner's account. Both notices shall be not later than — ten calendar days ~~prior to~~ after the end of the month ~~following the month~~ of production ~~of the volumes that were allocated to the refiner's account.~~ The notification will list the volumes by property.[3] Based on this information, the refiner will report to MMS on a Form MMS-2014, *Report of Sales and Royalty Remittance* (2014), its allocated volumes by lease and revenue source number[4]. The refiner also will calculate the value of the royalty oil[5], enter the value on the 2014, and remit payment to MMS. The refiner will report and pay via electronic commerce by the end of the month following the month of production. The lessee no longer will report on the 2014 for royalty oil taken in kind; however, the operators will continue to submit production reports.

The MMS will continue to perform AFS/PAAS comparisons, but will begin to compare information as soon as the production data are available in MMS's automated system. The MMS will work with the lease operator and/or lessee to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated. The lessee will settle volume discrepancies ~~in kind~~ as follows during the term of the contract.

~~When b~~Balancing volumes ~~are~~will be delivered in kind if delivered less than 60 calendar days after the month of production~~,~~. ~~t~~The refiner will report a separate line on the 2014 showing the month to which the adjusted volumes relate, and will pay for the adjusted volumes at the price specified by regulation.[6] If balancing volumes are available more than 60 calendar days after production month, refiner has the option to (1) balances in kind in next month after the

imbalance is identified and refiner report on 2014 or (2) have lessee remit in value to MMS for balance and lessee report to MMS as to balance. If the contract is no longer in effect, the lessee will be required to settle imbalances in value, at the price established by regulation for royalty oil taken in kind.

For the refiner: The RIK contract will specify reporting and paying requirements which, if not followed, may result assessment of interest or penalties or in contract termination. Refiner reports and substantiating records will be available for audit by MMS. For the lessee: Penalties will be assessed for failure to comply with the lease terms (for example, failure to deliver royalty oil).

Mobil Business Resources Corporation

P.O. Box 660614
Dallas, TX 75266-0614

June 19, 1997

Minerals Management Service
Royalty Management Program
ATTN: Mary Dietrick
P.O. Box 5760
Denver, CO 80217

MMS RIK PROPOSAL
PROCEDURE CHANGES

Dear Ms. Dietrick:

Mobil has reviewed the proposed changes to the MMS Royalty In Kind program, and has the following comments:

-On the introduction page, the statement, "having the refiner report and pay based on "delivered" volumes," , the term "delivered" should be clearly defined. My understanding is this volume will represent the MMS's interest times the volume metered at the delivery point attributed to the RIK lease. However, "delivered" volume could also be interpreted as the volum e the refiner receives each month.

-Mobil's administrative burden, as an operator and working interest partner will be significantly lessened.

-As agreed in the meeting, the designated delivery point would be moved on or near the lease The first footnote regarding offshore Federal leases and Facility Measurement Points (FMP) is clear and concise. However, the second footnote is vague and will require considerable clarification in final form. Lessees should have some input where the point of delivery is not the FMP. It may be necessary to have two set of criteria, one onshore, one offshore.

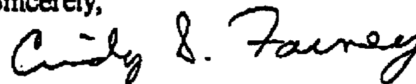
-The MMS AFS/PAAS comparison resolutions must include the refiner, since the refiner will be calculating and submitting the MMS 2014 reports.

-The sixth footnote requires any prior period adjustments to be reported under the appropriate sales period, but does not address which pricing will apply.

Another issue which was briefly addressed at the meeting and we feel must be resolved is how each lessee, for future audit purposes, would prove from its own records that we have met our lease obligation and delivered the royalty volume as designated by MMS.

If you have any questions or require additional information, please contact C.S. (Cindy) Farney at (214) 951-2819.

Sincerely,



CSF

C.S. Farney, Analyst
O& G Regulatory Compliance
Mobil Business Resources Corp.

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ATTORNEYS AT LAW

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BOULDER • COLORADO SPRINGS
DENVER TECH CENTER
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8350 EAST CRESCENT PARKWAY
ENGLEWOOD, COLORADO 80111

TELEPHONE (303) 290-1600
FACSIMILE (303) 290-1606

June 19, 1997

Via Facsimile and U.S. Mail

Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165
MS 3101
Denver, CO 80225

Re: Comments for Proposed Oil Royalty-in-Kind Procedure

Dear Sir or Madam:

Wyoming Refining Company (WRC) submits these comments on the *Minerals Management Service's (MMS) Proposed Oil Royalty-in-Kind* Procedure which was sent to us on June 13, 1997 via facsimile.

BACKGROUND AND SUMMARY OF WRC'S POSITION

As a small independent refiner in Newcastle, Wyoming, WRC has had a long term involvement in the federal government's royalty-in-kind (RIK) program. WRC hopes that any proposed changes to the rules and procedures affecting the program will further the program's ultimate goal—affording small refiners like WRC access to long term crude oil supplies.

MMS has been considering substantial changes to 30 CFR Parts 206 and 208, the rules that govern the RIK program. It is WRC's understanding that MMS is considering a pilot RIK program before finalizing changes to Rules 206 and 208. MMS seeks comments on the proposed procedure for this pilot program.

Subject to the specific comments discussed below, WRC supports the proposed procedure and RIK pilot program. WRC understands that under the pilot program, RIK oil will be sold based on a negotiated contract with the refiners. Therefore, WRC believes the pilot program is a workable improvement to the current procedures which create uncertainty for small refiners who may be subject to retroactive pricing due to post-sale audits.

COMMENTS ON MMS'S PROPOSED OIL ROYALTY-IN-KIND PROCEDURE

1. **"The refiner will be responsible for all downstream transportation, costs, and disposition of the oil, and will assume all associated risks." (footnote omitted)**

   Comments:

   Suggest replacing this sentence with the following:

"The refiner will be responsible for all issues downstream from the point of delivery" (retaining footnote).

2. **"The lease operator will notify the refiner not later than -- days prior to the end of the month following the month of production of the volumes that were allocated to the refiner's account. The notification will list the volumes by property.[3]"**

   "[3]In other words, the volumes allocated to lease basis wells, unit agreements, etc., will be separately identified."

   Comments:

   Suggest replacing these two sentences and footnote 3 with the following:

"The lease operator will notify the refiner not later than 15 days after the month of production of the volumes and gravities by property, separately identifying lease basis wells, unit agreements, etc., that were allocated to the refiner's account."

3. **"Based on this information, the refiner will report to MMS on a Form MMS-2014, *Report of Sales and Royalty Remittance* (2014), its allocated volumes by lease and revenue source number." (footnote omitted)**

   Comments:

   Suggest adding "and gravities" after "allocated volumes" (retaining footnote).

4. **"The refiner also will calculate the value of the royalty oil,[5] enter the value on the 2014, and remit payment to MMS."**

Comments:

Suggest inserting "based on delivered volumes and gravity" after "payment to MMS."

5. **"The lessee will settle volume discrepancies in kind during the term of the contract."**

Comments:

Suggest replacing this sentence with the following:

"The lessee will over or under deliver volume discrepancies to the refiner in kind during the term of the contract and will specifically give the refiner 10 days advance notice of the over or under delivery for nomination purposes."

6. **"When balancing volumes are delivered in kind, the refiner will report a separate line on the 2014 showing the month to which the adjusted volumes related, and will pay for the adjusted volumes at the price specified by regulation." (footnote omitted)**

Comments:

Suggest inserting "the contract during the month of the physical delivery to the refiner" in lieu of the word "regulation" at the end of this sentence (retaining footnote).

7. **"For the refiner: The RIK contract will specify reporting and paying requirements which, if not followed, may result [sic] assessment of interest or penalties or in contract termination. Refiner reports and substantiating records will be available for audit by MMS."**

Comments:

The draft procedure outlines a method for reconciling discrepancies with regard to volumes, but it contains no method for reconciling discrepancies in the calculation of value. It merely leaves the refiner open to the assessment of

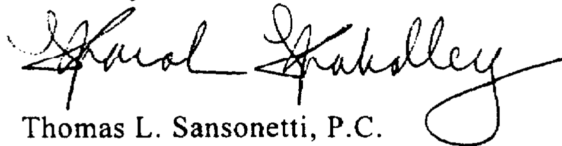
interest or penalties if the contractual reporting and paying requirements are not followed. For example, the draft procedure states that "MMS will work with the lease operator and/or lessee to resolve significant volume discrepancies as soon as they are identified, and will address minor variances either annually or after the contract has terminated." At a minimum, MMS should commit to work equally quickly and diligently with refiners to resolve any disagreements in the calculation of value, setting a time limit for MMS to identify any problems it has with the calculation and payment.

8. **"[5] The pricing formula for royalty oil purchased by a refiner under this program will be established in the contract. The formula to be used has not yet been established, but is being developed in conjunction with MMS's proposed oil valuation rule."**

Comments:

Although WRC generally has strong support for the Proposed Oil Royalty-in-Kind Procedure and the pilot RIK program, that support is contingent upon WRC's continued opportunity to have input into the process of shaping the pricing formula and oil valuation rule referenced in footnote 5. WRC believes the formula should be developed in the pilot program contract rather than in the rule. The rule should simply require the contract to contain or refer to pricing benchmarks and other provisions that reflect the current practices used in arm's length transactions and which the contracting parties agree establish market value for the oil.

Sincerely,



Thomas L. Sansonetti, P.C.
Karol L. Kahalley

COUNSEL FOR WYOMING REFINING COMPANY

cc: Bob Neufeld, Wyoming Refining Company

DTC:0045507.01