Karin Foster, Esq.
Executive Director
IPANM
5805 Mariola Place, NE
Albuquerque, NM 87111
Fosterassociates2005@Yahoo.com

Office of Natural Resources Revenue
UNBUNDLING WORKSHOP
Sponsored by the Independent Petroleum Association of New Mexico

June 24 – 25, 2013
Albuquerque, New Mexico

Government Speaker Contact Information

ONRR Speakers	**NMTRD Speakers**
Sarah Inderbitzin *Program Manager*, Office of Enforcement *Acting Program Manager*, Royalty Appeals Program Office of Natural Resources Revenue sarah.inderbitzin@onrr.gov (303) 231-3082 (Phone)	**Gilbert Martinez** *Bureau Chief* Federal Royalty Audit Bureau New Mexico Taxation & Revenue Dept. Santa Fe, NM gilbert.martinez@state.nm.us (505) 476-3651 (Phone)
Doug Ginley *Supervisory General Engineer* Asset Valuation - Unbundling Office of Natural Resources Revenue Douglas.ginley@onrr.gov (303) 231-3845 (Phone)	**Joan Ishimoto** Bureau Chief Oil and Gas Severance Tax Bureau NM Taxation and Revenue Dept 2968 West Rodeo Park Drive Rm 2057 Santa Fe, NM 87505 505-827-0953 (Phone)
Linda Shishido-Sheahan Supervisory Auditor Unbundling Program Office of Natural Resources Revenue Linda.shishido-sheahan@onrr.gov	

SARAH L. INDERBITZIN

Sarah L. Inderbitzin is the Program Manager for the Office of Natural Resources Revenue's Office of Enforcement, and is the Acting Program Manager for the Royalty Appeals Program. For 13 years prior to accepting a position with ONRR in February 2007, Ms. Inderbitzin was the Senior Attorney-Advisor for the Branch of Federal and Indian Royalties, Division of Mineral Resources, in the Office of the Solicitor of the Department of the Interior in Washington, D.C. In that capacity, she represented ONRR in royalty matters, including administrative appeals of royalty orders, ONRR civil penalties, and some appeals of offshore operational decisions.

Ms. Inderbitzin received her Bachelor of Science from the University of Maryland in 1985, a Juris Doctor, with honors, from Georgia State University, College of Law, in 1993, and an LL.M. in Environmental Law from the George Washington University, National Law Center, in 1997.

The Marketable Condition Rule

Presented by:
Sarah Inderbitzin, Program Manager, Office of Enforcement,
Acting Program Manager, Royalty Appeals Program

IPAANM
June 25, 2013

Industry Compliance • *Accurate Revenues and Data* • *Professionalism & Integrity*

The Regulation

- Promulgated originally in 1942, requires lessees to put gas into marketable condition and to pay royalty on the value of the gas in marketable condition without deduction for the costs of treatment

- The lessee must place gas in marketable condition . . . at no cost to the Federal Government. 30 C.F.R. § 1206.152(i) (federal gas), § 1206.174(h) (Indian gas)

The Regulation

- If a lessee sells "unmarketable" gas at a lower cost, the lessee must increase the gross proceeds for purposes of royalty calculation "to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services" to place the gas in marketable condition. 30 C.F.R. § 1206.152(i) (federal gas), § 1206.174(h) (Indian gas)

- To take a simple example, assume it costs a producer 20¢ to put gas in marketable condition by dehydrating and compressing it, and the producer sells the dehydrated and pressurized gas for $1. However, the producer pays royalties based upon gross proceeds of 80¢. Is that the gross proceeds for royalty purposes?

The Definition

The regulations define marketable condition as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 1206.151 (federal gas), § 1206.171 (Indian gas).

What Processes Are Covered?

Treating gas to put it into marketable condition involves:

- Gathering - the movement of lease production to a central accumulation and/or treatment point on the lease, unit, or communitized area, or to a central accumulation or treatment point off the lease, unit, or communitized area as approved by BLM or ONRR OCS operations personnel for onshore and OCS leases, respectively." 30 C.F.R. § 1206.151 (federal gas), § 1206.171 (Indian gas)
- Compression – means the process of raising the pressure of the gas. 30 C.F.R. § 1206.151(federal gas), § 1206.171 (Indian gas)
- Dehydration - the removal of water vapor
- Removal of acid gases - usually the removal of hydrogen sulfide ("sweetening") or carbon dioxide. Also referred to as "treatment"

Major Principles From MCR Cases

Lessees must compress, gather, and dehydrate gas at no cost to the lessor

- ***The Texas Co.,*** 64 I.D. 76 (1957) - costs of gathering and compression were not deductible in determining the royalty value of the gas because "[t]he lessee has not shown that the gas can be marketed at the pressure with which it comes from the wells"
- ***California Co. v. Udall***, 296 F.2d 384 (D.C. Cir. 1961) - costs of gathering, compression, and dehydration were necessary to put the production into marketable condition because there was "no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content"
- ***Devon Energy Corporation v. Kempthorne****,* 551 F.3d 1030 (D.C. Cir. 2008), *cert. denied,*130 S. Ct. 86 (2009) - compression and dehydration are necessary to place gas into marketable condition

Major Principles From MCR Cases

Lessees must remove sulphur (sweeten) and carbon dioxide (CO_2) at no cost to the lessor

- ***Apache Corp.,***127 IBLA 215 (1993) - ONRR's disallowance of a price reduction for sweetening in determining royalty value was proper
- ***Texaco, Inc. v. Quarterman***, No. 96-CV-008J (D. Wyo. Aug. 20, 1996) - upheld ONRR order requiring Texaco to increase the gross proceeds by the amount the sales price was reduced by a per Mcf fee the purchaser charged to remove hydrogen sulfide
- ***Amoco Prod. Co. v. Watson****,* 410 F.3d 722, 725 (D.C. Cir. 2005), aff'd sub nom., BP Amoco Prod. Co. v. Burton, 549 U.S. 84 (2006) - the Assistant Secretary properly required the lessees to remove CO_2 at no cost to the lessor, even though the CO_2 removal took place a considerable distance downstream from the leases

Major Principles From MCR Cases

The lessee cannot deduct what it pays another entity to perform the processes necessary to place the gas into marketable condition

- ***Placid Oil Co.,*** 70 I.D. 438 (1963) - the lessee cannot pay its affiliate to perform the processes necessary to place the gas into marketable condition so disallowed deductions for the costs (payments to the affiliate) of gathering, dehydrating, compressing the gas
- ***Exxon Co. USA***, 121 IBLA 234 (1991) - Exxon had to add to its reported value the amount by which the gas sales price was reduced to compensate the purchaser for sweetening. Lessees cannot make the costs of treatment deductible by transferring the treatment function to the purchaser

Major Principles From MCR Cases

The fact that a purchaser agrees to accept untreated gas does not mean the gas was marketable in its natural state. In other words, the fact that you sell or transfer title at the wellhead does not mean the gas is in marketable condition at the wellhead

- ***California Co.*** - "almost anything can be sold, if the price is no consideration. In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content"
- ***Amoco and Devon*** - the fact that the gas was sold untreated at the well head does not mean it was in marketable condition at the wellhead

Major Principles From MCR Cases

A lessee cannot shift the location of where gas is marketable by having another entity perform the processes necessary to place production into marketable condition

- ***Bailey D. Gothard*** - mere fact a purchaser was willing to buy gas at discounted price for its costs to place gas into marketable condition does not mean the gas was marketable at that point. "Any other result would elevate form over substance, and create a huge loophole whereby federal lessees could reduce their royalty obligations by shifting the costs of gathering and compression to buyers in a producer-created market, avoiding the marketability requirements of the "real" established market"

Major Principles From MCR Cases

Lessees must pay royalties on reimbursements they receive for gathering, compression, and treatment because they are costs of placing the gas into marketable condition

- ***Mesa Operating Ltd. v. DOI****,* 931 F.2d 318 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992); ***Oryx Energy Co. v. DOI****,* No. 92-C-1052 E (N.D. Okla. 1997); and ***Amerada Hess Corp. v. DOI***, 170 F.3d 1032 (10th Cir. 1999) - royalties are due on gross proceeds accruing to the lessee. This includes payments for costs of treatment, measuring, gathering, compressing, sweetening, and dehydrating where the services are necessary to place gas in marketable condition. Thus, where the purchaser reimburses the lessee for such costs, the payments become part of the value of production (gross proceeds) subject to royalty

Major Principles From MCR Cases

The fact that a marketable condition cost also may be part of processing does not make it a deductible processing cost

- ***Shoshone & Arapaho Tribes v. Hodel***, 903 F.3d 784 (10th Cir. 1990) - upheld ONRR's denial of a deduction for the costs of compressors located at the inlet of a gas processing plant. Even though the compressors increased gas flow pressure within the plant (which was a processing function), they also "increase the gas flow pressure to the level necessary to pass through the pipeline and ultimately to the purchaser of the gas"
- You must allocate the compressor costs between marketable condition and processing
- For example, assume the compressor at the plant inlet boosts pressure to 1500 psi and the pipeline pressure requirement is 1200 psi. How much of that compressor's costs are nondeductible costs to place the gas into marketable condition?

Major Principles From MCR Cases

There is no "geographic limitation" to the marketable condition rule, except for gathering, which ends at the BLM or BSEE approved royalty measurement point. Thus, there is no bright-line geographic limit to the marketable condition rule

- ***Amoco*** - the government may apply the marketable condition rule as far downstream as costs are incurred to place production into marketable condition
- ***Devon*** - there are many decisions where, with respect to natural gas, DOI uniformly denied a transportation deduction based upon the geographic location of the natural gas

Major Principles From MCR Cases

If a lessee sells some gas that meets the definition of marketable condition for a particular market, that does not convert all gas sold into marketable condition. One must look to the market into which the gas at issue is sold to determine what marketable condition is for that gas

- ***Amoco -*** although some gas was sold without removing CO_2, DOI properly required lessees to condition the rest of the gas to pipeline CO_2 content requirements to serve more distant markets into which it was sold
- ***Devon*** - although some gas was sold at lower pressure because the pipeline into which it was sold had a lower pressure requirement, the remaining gas had to be compressed to the higher pressure requirement of the pipeline into which it was sold
- ***Beartooth Oil and Gas Co. v. Lujan***, No. CV 92-99-BLG (D. Mont. Sept. 22, 1993) - most of the gas was at sufficient pressure to travel to purchaser's compressor. However, some of the gas had to be compressed at the lease to be accepted into the purchaser's line and those were non-deductible marketable condition costs

Major Principles From MCR Cases

Marketable condition means gas treated so that it is marketable for delivery to the pipeline

- ***Amoco*** - lessees must treat gas to pipeline CO_2 requirements to serve distant markets into which it was sold
- ***Devon*** - gas must be in marketable condition for the market it serves, so must be at pressure needed to enter the pipeline taking it to market
- ***R.E. Yarbrough Co***., 122 IBLA 217, 221 (1993) - compression, dehydration, and gathering costs are necessary to put gas in marketable condition for delivery to pipeline buyer
- ***Shoshone*** - denial of deduction for compression costs because they "increase the gas flow pressure to the level necessary to pass through the pipeline and ultimately to the purchaser of the gas"
- ***The Texas Co***. - denied deduction for cost to compress low pressure gas to the pressure required to enter purchaser's pipeline
- ***J-W Operating Co***.,159 IBLA 1 (2003) - "it has been held repeatedly that the dehydration of gas to meet market specifications for water content and the compression of gas to the pressure required for entry into the buyer's pipeline are not deductible"

Major Principles From MCR Cases

Because one must look to the market into which the gas is sold, one must look at the contracts that are "typical" for gas sold to that market

- ***Amoco*** - the regulations do not require ONRR to define typical sales contracts – and thus marketable condition – as relating to transactions at the leasehold or immediately nearby
- ***Devon*** - the court rejected Devon's argument that ONRR did not look at contracts "typical for the field or area" because it only looked at Devon's contracts for the particular gas sold. Like the lessees in ***Amoco,*** Devon asserted that ONRR defines marketable condition as meaning gas conditioned for the market it serves. That is true because the "typical" contracts for the area in ***Devon*** were for treated gas, *i.e.* the market was for treated gas. In ***Devon,*** like ***California Co***., "there is no evidence of a market for the gas in the condition it comes from the wells. The only market this record shows was for this gas at certain pressure and certain minimum water and hydrocarbon content"

Major Principles From MCR Cases

The fact that one aspect of placing production into marketable condition ends or has been accomplished does not mean that the production is in marketable condition in all respects

- ***Nexen Petroleum USA Inc. v. Norton***, No. 02-3543, 2004 U.S. Dist. LEXIS 5471 (E.D. La. 2004) - "in certain circumstances, there may be transportation costs incurred prior to treatment that may be deducted from royalty." In that case, "once treated" the product was in marketable condition
- ***Devon*** - just because gathering ends and a lessee may deduct pipeline costs as transportation allowances downstream of the point where gathering ends does not mean that the production is in marketable condition at that point. If the production must be further dehydrated, compressed, sweetened, etc., downstream from that point, that production is not in marketable condition until all of those processes are performed – even where the processes are performed sequentially

Major Principles From MCR Cases

You only have to get production into marketable condition once

- ***Devon*** - once gas was compressed to the pipeline pressure requirement, subsequent compression was allowed as a transportation allowance
- For example, assume gas is produced at 100 psi and the pipeline pressure requirement is 800 psi. Assume further that pressure is increased to 600 psi at Compressor #1, 800 psi at Compressor # 2, and 1000 psi at Compressor #3. Which compressor(s) costs are nondeductible costs to place production into marketable condition?

Major Principles From MCR Cases

Per *Xeno, Inc., 134 IBLA 172 (1995)*, gas may be in marketable condition at the wellhead if:

- There is a market at the wellhead evidenced by competing offers from multiple purchasers;
- The sales price is the same as that for gas that is compressed; and
- The pressure of the gas at the wellhead is adequate to gain access to the pipeline market
- If the lessee has the choice of several pipelines in which it can ship its gas, is that evidence of competing offers from multiple purchasers?

Major Principles From MCR Cases

Lessees must offer affirmative evidence to support an assertion the costs of compression, dehydration, and treatment are not necessary to place the gas in marketable condition or that the gas was already marketable prior to compression, dehydration,and treatment

Burlington Resources Oil & Gas Co., 183 IBLA 333, 352 (2013) - in *Burlington*, Burlington claimed that its gas was in marketable condition at the wellhead and it was entitled to deduct 100 percent of the costs of treatment, compression, and dehydration a third party performed. The IBLA held the "burden rests properly on the lessee to demonstrate that these costs [of compression, dehydration, and sweetening] were not necessary to place the unprocessed gas in marketable condition and incurred only to transport and process its gas."

Major Principles From MCR Cases

Where gas is processed for the removal of acid gases, commonly referred to as "sweetening," no processing cost deduction shall be allowed for such costs unless the acid gases are further processed into a gas plant product. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, ONRR will not grant any processing allowance for processing lease production which is not royalty bearing. 30 C.F.R. § 1206.158(d)(1) (federal gas), § 1206.179(d) (Indian gas)

- ***Mobil Exploration and Producing v. Babbitt,*** No. 99-3204, Slip op. at 4-5 (D.D.C. Mar. 30, 2001) - ExxonMobil's gas sulfur treatment process was nothing more than a "sweetening" process that is similar to other treatment processes in the industry used to place gas into marketable condition. Had the lessee captured and sold the sulfur, the cost to sweeten would have been a deductible processing cost
- ***Amoco*** - movement of CO_2 to a treatment plant was to facilitate treatment to remove the CO_2, a non-deductible cost of putting production into marketable condition. Had the lessee captured the CO_2 and sold it after removal, the removal process would have qualified as processing, and the lessee could have taken a processing allowance

Major Principles From MCR Cases

Lessees may not deduct the costs for boosting residue gas, *i.e.*, compression of the methane, at a gas processing plant. 30 C.F.R. § 1202.151(b) (federal gas)

- ***Devon*** - boosting is not deductible even if gas is in marketable condition before entering the facility

The marketable condition rule applies to POP contracts even when title transfers at the wellhead

- ***Citation Oil & Gas Corp. v. DOI***, No. 10-20729, 2011 U.S. App. LEXIS 21448 (5th Cir. 2011) - Citation improperly deducted the costs for treatment and compression that its purchaser deducted from what it paid to Citation
- Thus, the type of contract does not change application of the marketable condition rule, so it also applies to keepwhole contracts

Major Principles From MCR Cases

The marketable condition cases such as *Amoco* and *Devon* apply to conventional gas

- Neither case distinguished between conventional and coal bed methane gas – both interpret a regulation that applies to all gas
- In *Amoco* some of the gas at issue was conventional gas
- In *Devon*, the District court agreed with DOI that the federal gas rules apply to bot CBM and conventional gas
- All of the foundational cases *Amoco* and *Devon* applied dealt with conventional gas. ***The Texas Co.; California Co. v. Udall; Apache Corp.; Texaco, Inc.; Placid Oil Co.; Exxon Co. USA; Mesa; Oryx; Amerada Hess; R.E. Yarbrough Co.; Shoshone; Nexen; Mobil Exploration and Producing; Citation Oil & Gas Corp.***

Major Principles From MCR Cases

The marketable condition rule applies to arm's-length transportation contracts

- Both ***Amoco*** and ***Devon*** involved non-arm's-length and arm's-length transactions, as did numerous other cases

Gas may be in marketable condition after it leaves the plant if no treatment or dehydration occurs after the plant

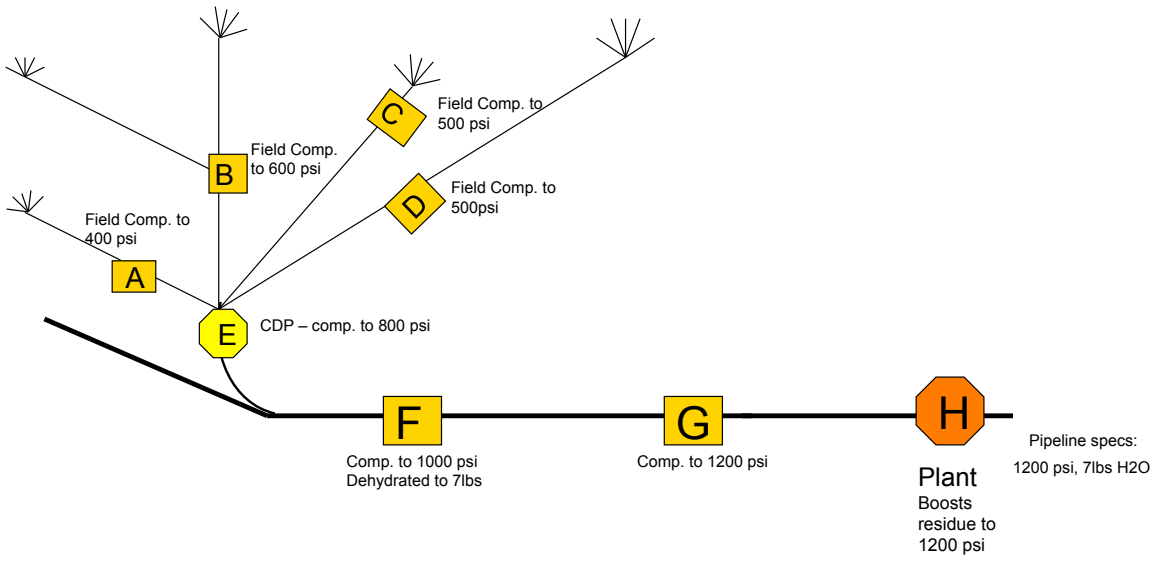
- Compression of residue gas after the plant may not be deductible because it is boosting under 30 C.F.R. § 1202.151(b)

A Word on Enforcement

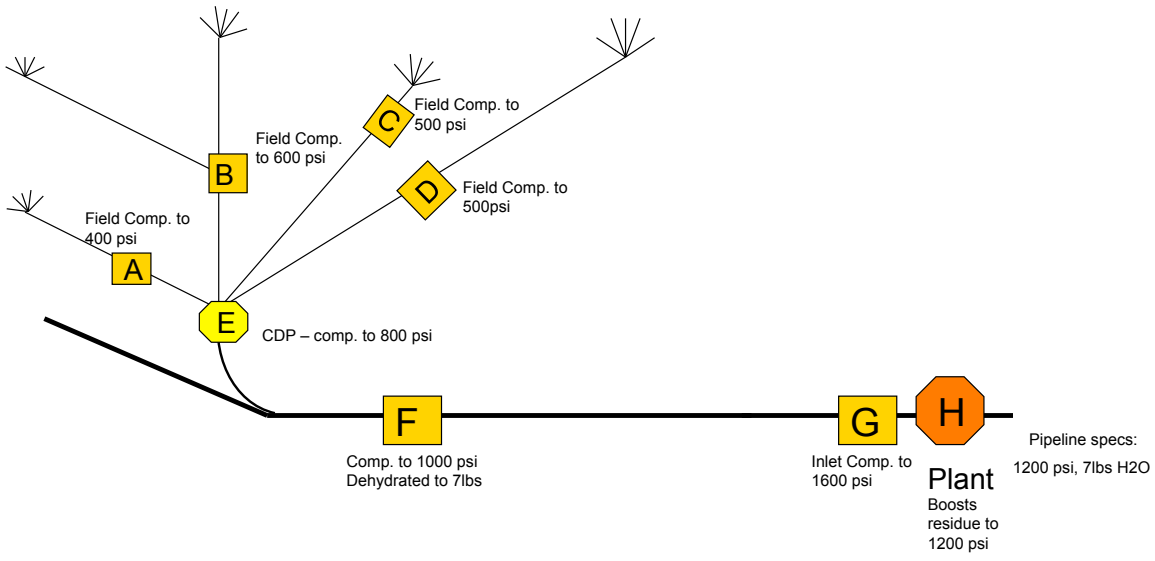
What may ONRR do if you make not attempt to determine nondeductible marketable condition costs?

- ONRR refers cases it believes constitute "false claims" under the False Claims Act to the Office of Inspector General and Department Of Justice
- Any incorrect Form ONRR-2014 that has a royalty consequence may constitute a "false claim"
- Therefore, a lessee who makes no attempt to unbundle the fees it is charged for the costs to compress, dehydrate, and treat its gas, and deducts 100 percent of those costs as transportation, may be considered to have made a "false claim."

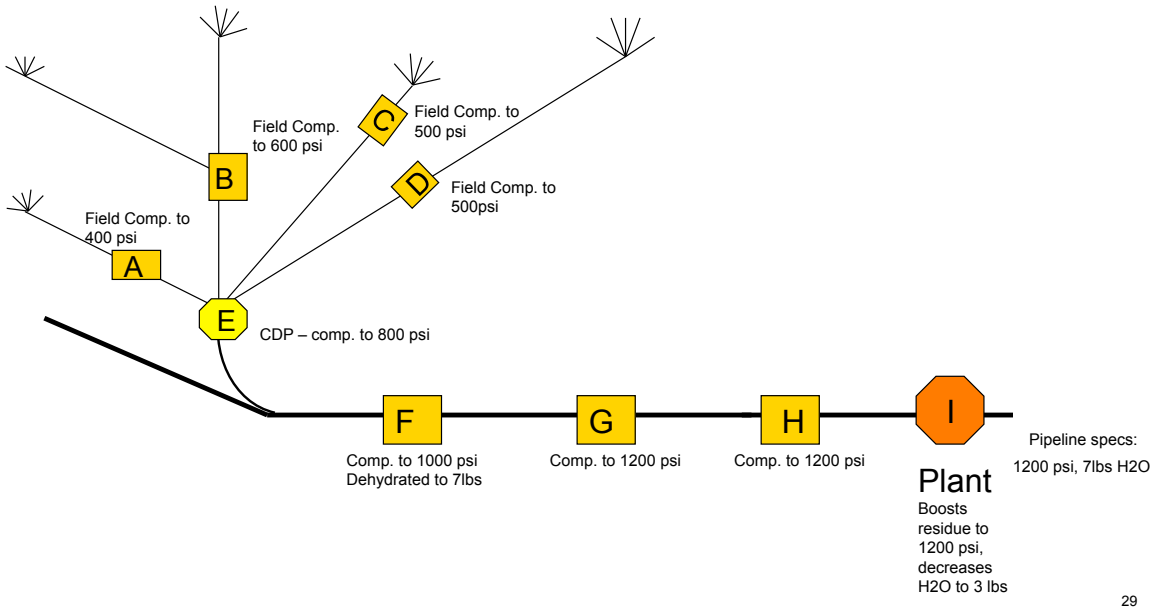
What is deductible pipeline? Dehydration? Compression?



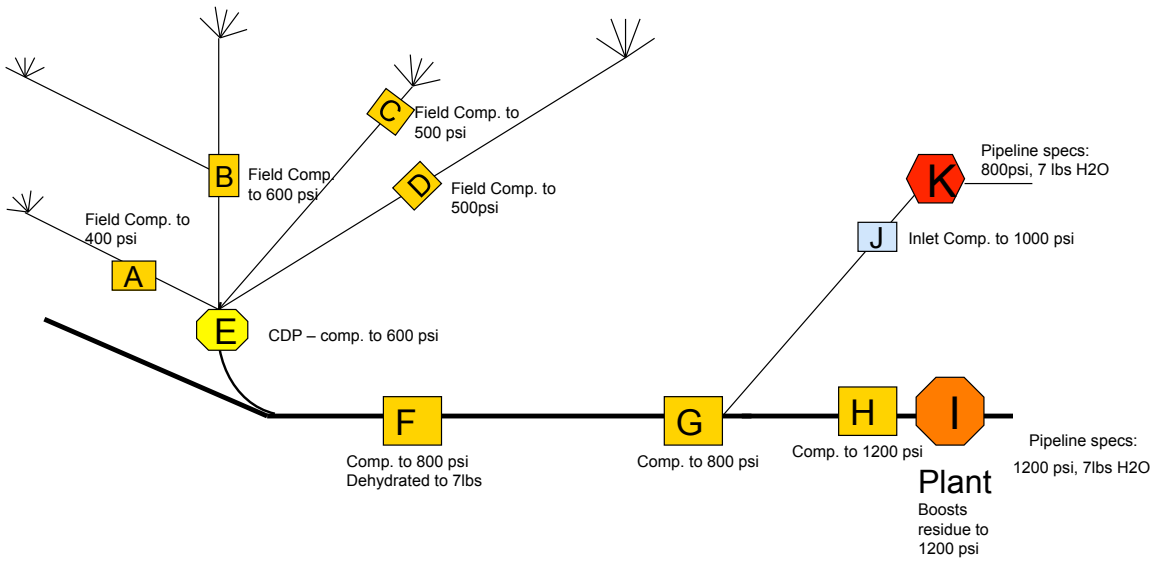
What is deductible dehydration? Compression?



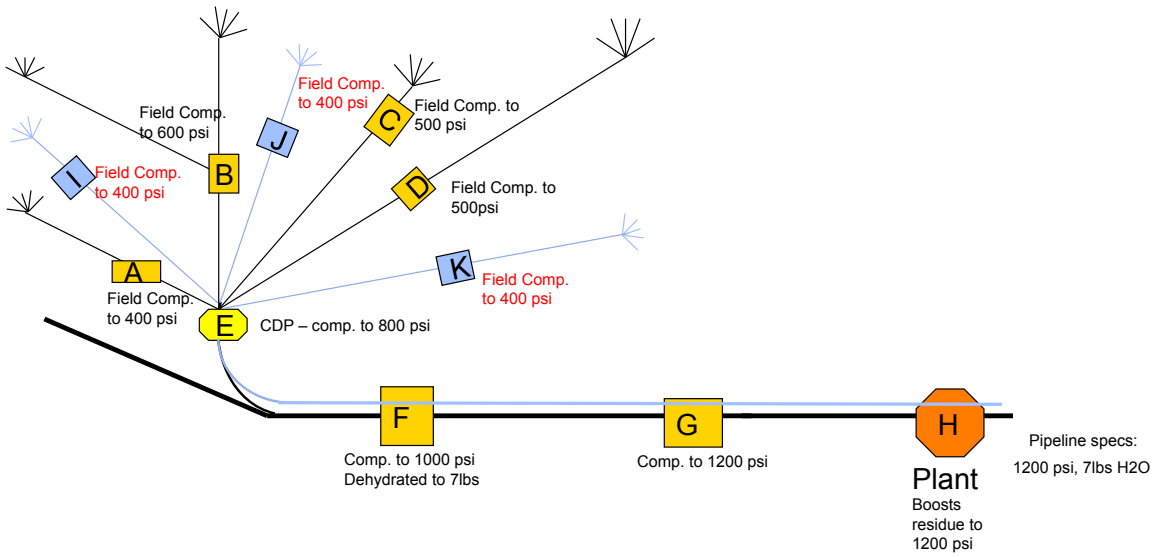
What is deductible dehydration? Compression?



For gas to plant I, what is deductible dehydration? Compression? For gas to plant K, what is deductible dehydration? Compression?



Looping & Global Compression
What is deductible pipeline? Dehydration? Compression?



Gilbert P. Martinez is a native Santa Fean currently employed by the New Mexico Taxation and Revenue Department as the Bureau Chief of the Federal Royalty Audit Bureau in Santa Fe. He has 11 years of oil and gas royalty audit experience as an auditor, and as a supervisor. Gilbert has led the group responsible for the Permian Basin costs project which has studied and identified the many unique features of gas processing in southeastern New Mexico.

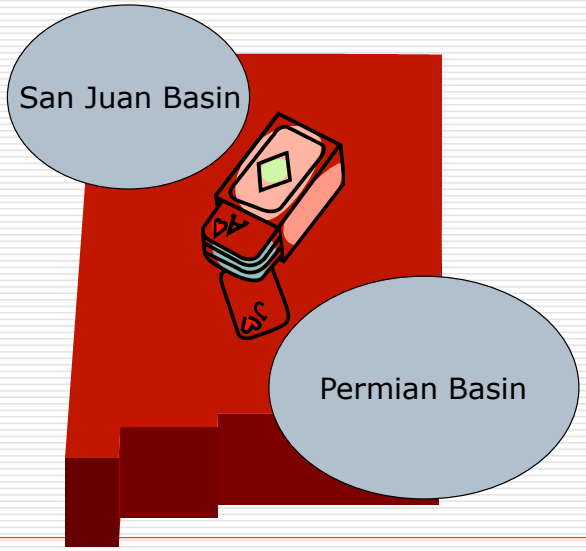
Mr. Martinez attended the University of Dallas and holds a Bachelors degree in Business Operations Management**.** From 1991 – 1999 he worked for mutual fund giant Fidelity Investments as a Series 6 & 63 Retirement Specialist and Auditor in their Dallas and Cincinnati offices. Mr. Martinez was a partner in an advertising agency briefly before returning to New Mexico.

In 2008 he earned a Masters of Business Administration degree from New Mexico Highlands University. Mr. Martinez is an active volunteer with Big Brothers Big Sisters of Northern New Mexico and the American Red Cross.

Unbundling: The Sequel

Disclaimer: the views expressed in this paper are those of the author and not of the Office of Natural Resource Revenue or any other agency, company, or party.

The Geology of New Mexico



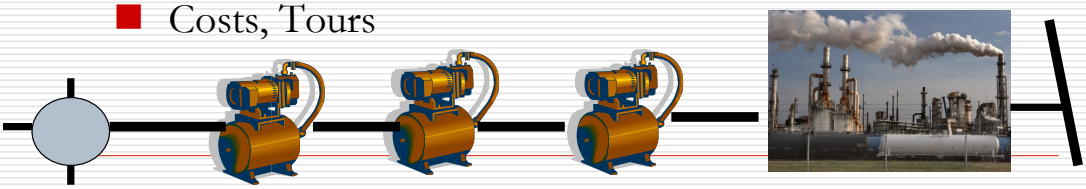
The Scope

- Permian Plants vs. San Juan Plants 3:1

9 active unbundling projects

Data Collection & Plant Tours

- Requested identical information
  - Maps, schematics
  - Compressor Locations
  - Inlet and Discharge Pressures
  - Dehydrators and Water Content
  - Mainline specs that determined Marketable Condition
  - Costs, Tours



San Juan vs. Permian: The Differences

- Gas is Sour, H2S treating fees are typically not allowable
- Majority of Transactions are POP in nature
  - No 'fee' to unbundle

- Citation decision supports marketable condition for POP contracts
  - 9/2010, Citation Oil & Gas plaintiff; U.S. Dept. of the Interior Defendant
  - U.S. District Court, Houston Division
  - Case 4:08-cv-01977, civil action H-8-1977

Unbundling a POP

- Use plant retainage as cost to gather and process
  - This is the true cost to transport and process
  - Divide between gathering and processing
- Use allowed/disallowed ratios to gross up producers net proceeds
- Recalculate producers royalties based on revised proceeds

Recalculating Royalties under a POP Contract

Based on the Marketable Condition Rule

Given

Total Proceeds	$ 44,635.56	(add back fees and taxes)
Residue Proceeds	$ 18,794.97	
NGL Proceeds	$ 25,840.59	
POP %	89%	(11% plant retainage)

Auditor/ONRR Pre-Calculated Percentages

How plant retainage will be split between transportation and processing

		Total Bundled System Costs	Transp. Costs	Processing Costs
Transportation %	20%	$250,000	$50,000	
Processing %	80%	$250,000		$200,000

Allowed & Disallowed Percentages based on Marketable Condition analysis

Allowed Transportation %	30%	(70% Disallowed)
Allowed Processing %	40%	(60% Disallowed)

Recalculate Royalties Due

STEP 1

Gross Up Net Proceeds

100% Residue	$ 21,117.94	Net Residue /POP%
100% NGL	$ 29,034.37	Net NGL / POP%
100% Value	$ 50,152.31	

STEP 2

Determine allowable costs based on plant retainage

Costs	**$ 5,516.75**	Grossed up proceeds * plant retainage
Gathering Costs	$ 1,103.35	Costs * Gathering %
Disallowed Gathering Costs	**$ 772.35**	Gathering Costs * Dis-allowed %
Processing Costs	$ 4,413.40	Costs * Processing %
Disallowed Processing Costs	**$ 2,648.04**	Processing Costs * Dis-allowed %

STEP 3

Total Reporting Impact

New Sales Value to report	$ 48,055.95	Original Gross Proceeds + Disallowed Gathering Costs + Disaalowed Processing Costs ($44,635.56 + $772.35 + $2,648.04)
New Royalty Value to report	$ 6,006.99	(New Sales value * Royalty Rate)
	$ 427.55	(additional Royalty value)

Questions

Douglas Ginley works in the Office of Natural Resources Revenue, Asset Valuations and is the Manager for the Unbundling Program. Doug has over 25 years of Project Management experience, working in both the public and private sectors. In his 15 plus years with ONRR, Doug has managed a wide range of projects related to compliance activities, industry and market analysis, and royalty reporting. Doug holds a PMP certification, is a graduate of the Colorado School of Mines in Chemical and Petroleum Engineering, and received a Master's degree in Business Administration from the University of Colorado.

Linda Shishido is a Supervisory Auditor for the Office of Natural Resources Revenue, Audit and Compliance Management, and manages the Unbundling and Gas Plant Teams. Linda has over 22 years of experience with ONRR, including areas in auditing, enforcement, and asset sales and accounting. Linda received a Bachelor of Science in Business Administration from the University of Arizona.

IPANM Unbundling Session Cost Allocation

Presented by
Doug Ginley and Linda Shishido-Sheahan

Office of Natural Resources Revenue

Disclaimer: The statements or opinions expressed in this presentation and any follow-up questions at the IPANM meeting (June 25th, 2013) do not necessarily represent the views of ONRR or the Department of the Interior.

What is Unbundling?

- Unbundling = the process of taking a gas transportation and/or processing fee and determining the *allowed* and *disallowed* costs for Royalty Reporting and Payment.
  - includes separating the Gathering/Transportation Fees from Processing Fees
  - includes employing appropriate Unbundling Cost Allocations (UCAs)* to the fees as determined through the application of the Marketable Condition Rule

**Note: A UCA is the percent of a fee that is allowable (there will likely be a different percentage for Transportation and Processing)*

ONRR's UNBUNDLING PROGRAM

- **A new ONRR program under:**
  - **Asset Valuation (AV)**
  - **Audit and Compliance Management (ACM)**
- **For gas products only**
  - **Conventional**
  - **Unconventional – Coal Bed Methane (CBM)**
- **Based upon Marketable Condition Rule**
- **For Transportation Systems and Gas Plants**
- **Determines allowed Transportation Costs**
- **Determines allowed Processing Costs**

UNBUNDLING STRATEGY

ONRR Unbundling

ASSET VALUATION UNBUNDLING TEAM
Leadership, Direction, and Engineering

AUDIT & COMPLIANCE UNBUNDLING TEAM
Audit and Data Collection

COLLABORATION WITH STATES AND TRIBES CONTRACTORS

AV RESPONSIBILITIES

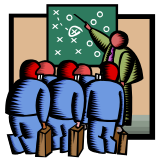
- **Leadership and Direction**
- **Promotes Collaboration**
- **Obtains Information**
- **Oversees Contractors**
- **Provides Technical Support**
- **Publishes Unbundling Cost Allocations (UCAs)**

ACM RESPONSIBILITIES

- Perform Audits and Compliance Reviews of Transportation and Processing Allowances
- Collaborate with States and Tribes
- Assist with Unbundling Issues
- Issue Data Requests
- Collect Data
- Analyze and Provide Data to AV

RISK ANALYSIS
Where to Investigate?

- ✓ 189 Gas Plants
- ✓ 22 Criteria Established for each Gas Plant
- ✓ 7 of the 22 Criteria used to Prioritize the Gas Plants
- ✓ 29 High Priority Gas Plants account for more than 80 % of the FY 2011 volume
- ✓ ONRR will Evaluate Associated Transportation Systems when we evaluate each Gas Plant



GAS PLANT LIST FOR FY 2013
(Tentative)

Plant Name	Designated Priority
BLANCO GAS PLANT	A
CHACO GAS PLANT	A
HUERFANO PROCESSING PLANT	A
LYBROOK GAS PLANT	A
OPAL GAS PLANT	A
PASCAGOULA GAS PLANT	A

GAS PLANT LIST FOR FY 2014
(Tentative)

Plant Name	Designated Priority
BLACK FORK	B
CHIPITA GAS PLANT	B
LAROSE GAS PLANT	B
MILAGRO GAS PLANT	B
NORTH TERREBONNE GAS PLANT	B
SAN JUAN BASIN GAS PLANT	B
YSCLOSKEY GAS PLANT	B

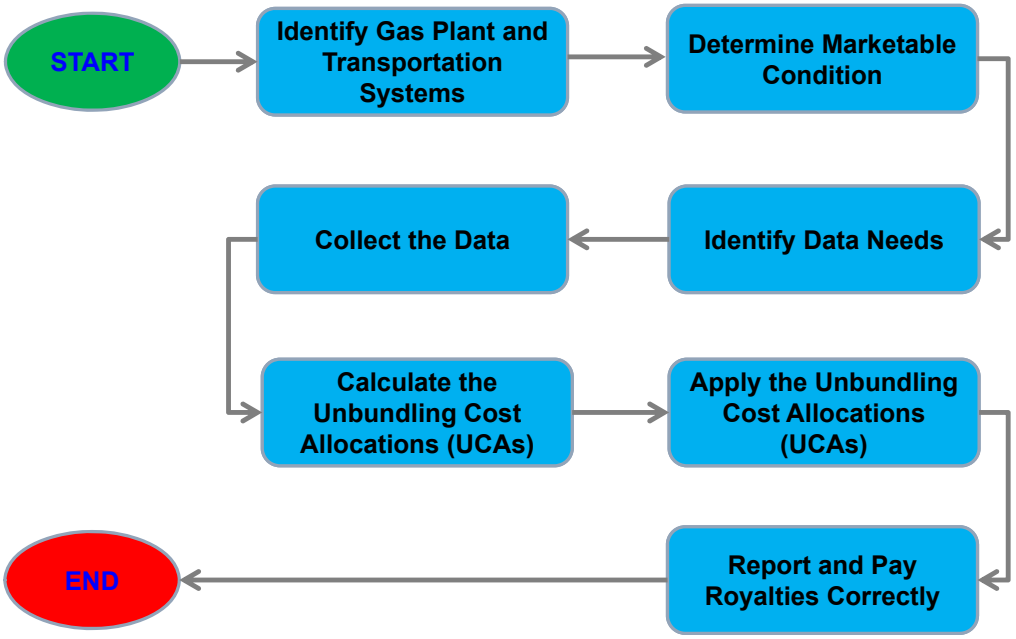
GAS PLANT LIST FOR FY 2015 (Tentative)

Plant Name	Designated Priority
BAIROIL-WERTZ	C
CALUMET GAS PLANT	C
CARLSBAD GATHERING SYSTEM	C
ECHO SPRINGS GAS PLANT	C
EUNICE GAS PLANT	C
EXXON MOBILE BAY TREATING FAC	C
GARDEN CITY GAS PLANT	C
IGNACIO GAS PLANT	C
IOWA GAS PLANT	C
KUTZ GAS PLANT	C
LA BARGE (SHUTE CREEK)	C
PAINTER GAS PLANT	C
SEA ROBIN GAS PLANT	C
TOCA GAS PLANT	C
VALVERDE GAS PLANT	C
VENICE GAS PLANT	C

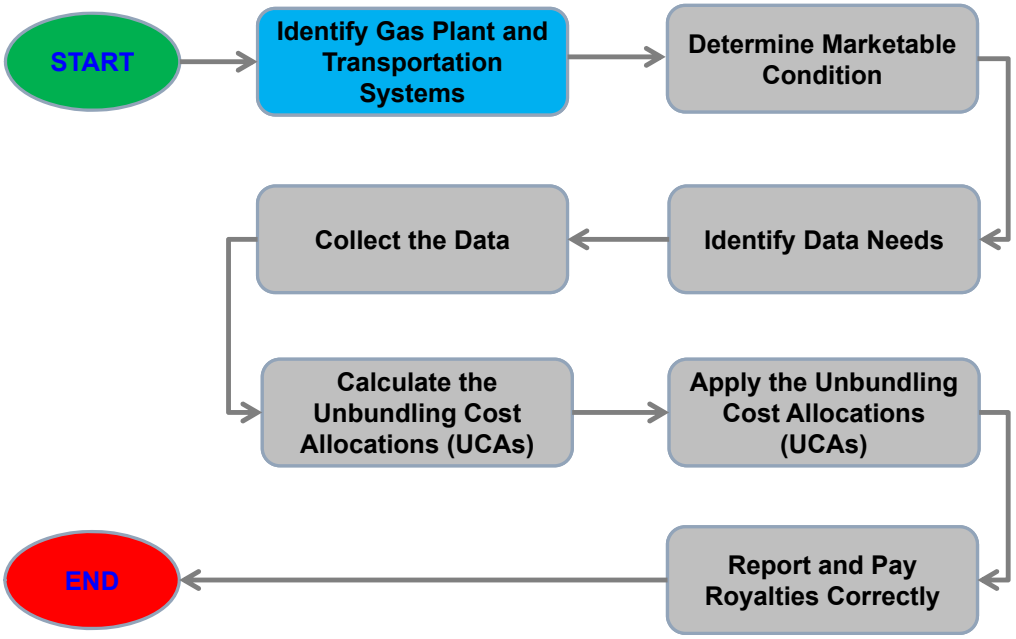
What is Expected of Industry

- Properly Report and Pay Royalties
- Correctly calculate transportation and processing allowances
  - Option 1 – Take no allowance
  - Option 2 - Unbundle
    - Calculate your own UCAs
    - Use ONRR UCAs if available

THE UNBUNDLING PROCESS

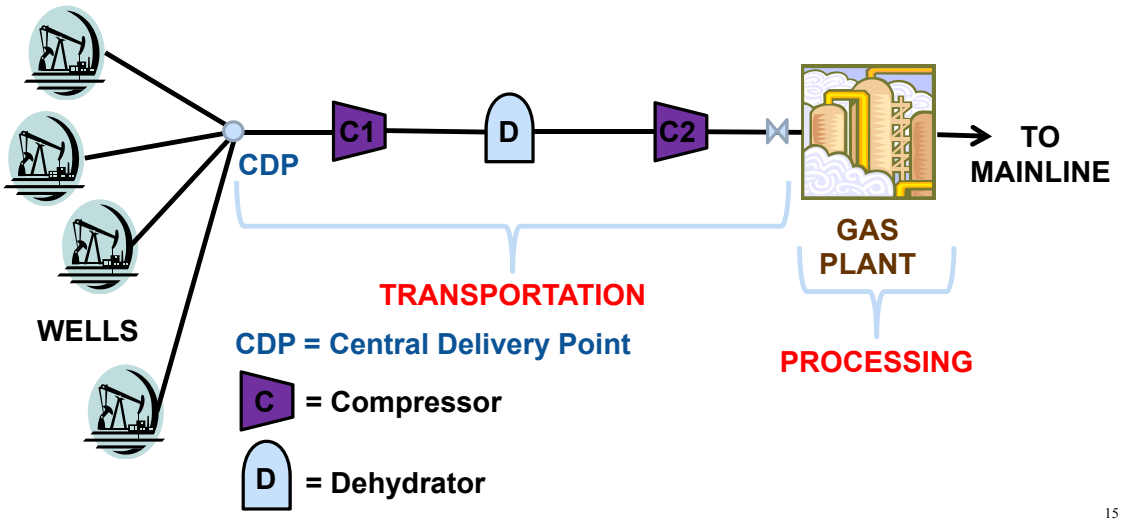


THE UNBUNDLING PROCESS

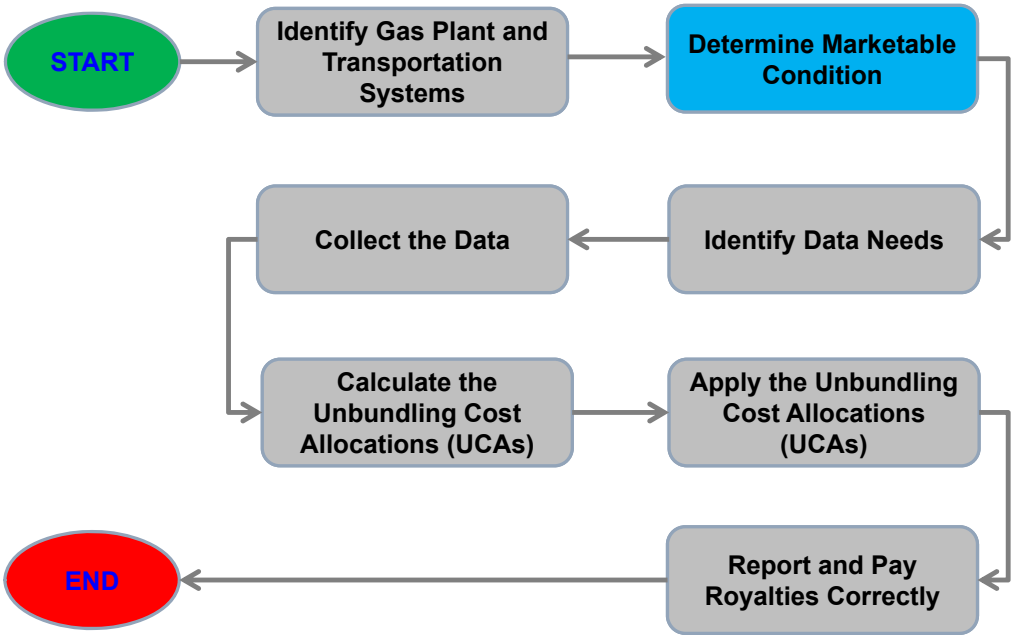


An Example of the Unbundling Process
(*Identify Gas Plant and Transportation System*)

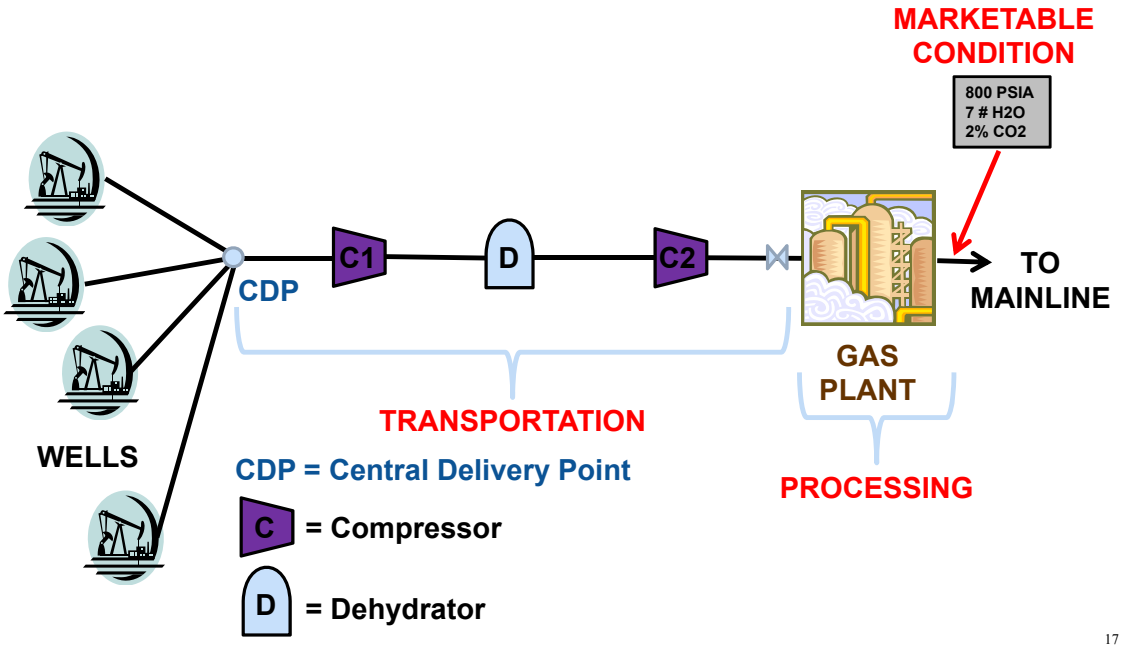
Obtain Maps and Schematics



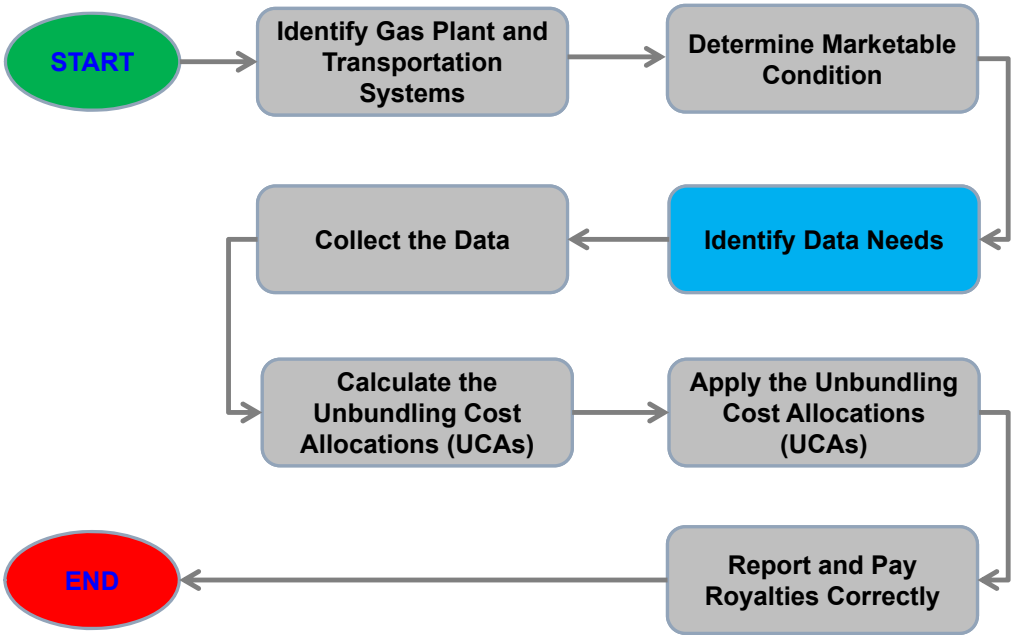
THE UNBUNDLING PROCESS



An Example of the Unbundling Process
(*Determine Marketable Condition*)



THE UNBUNDLING PROCESS



An Example of the Unbundling Process
(*Identify Data Needs*)

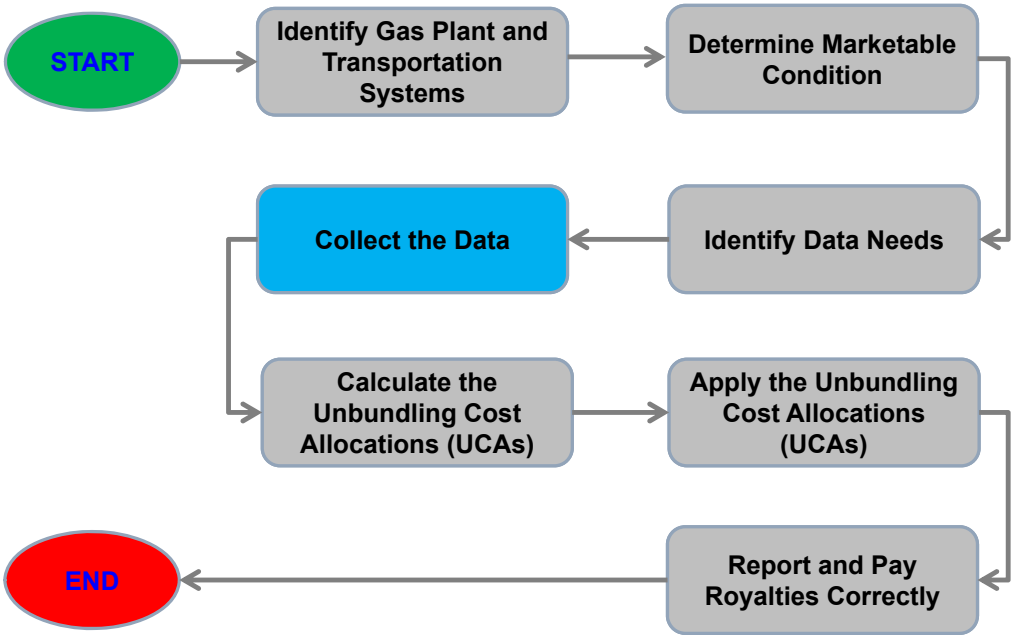
- Physical Data for each Process Unit/CDP
  - –Flow rates
  - –Pressure, Temperature, H_2O content, CO_2 %, other?
- Cost Data*
  - –Total System Cost
  - –Transportation Cost
  - –Processing Cost
  - –Cost for each major Processing Unit

* Cost Data = ideally includes capital cost (including installation), operating cost, maintenance cost, and overhead cost

An Example of the Unbundling Process
(*Identify Data Needs*)

More detailed information is available on the ONRR Unbundling website (*coming soon*), and in your packet of information

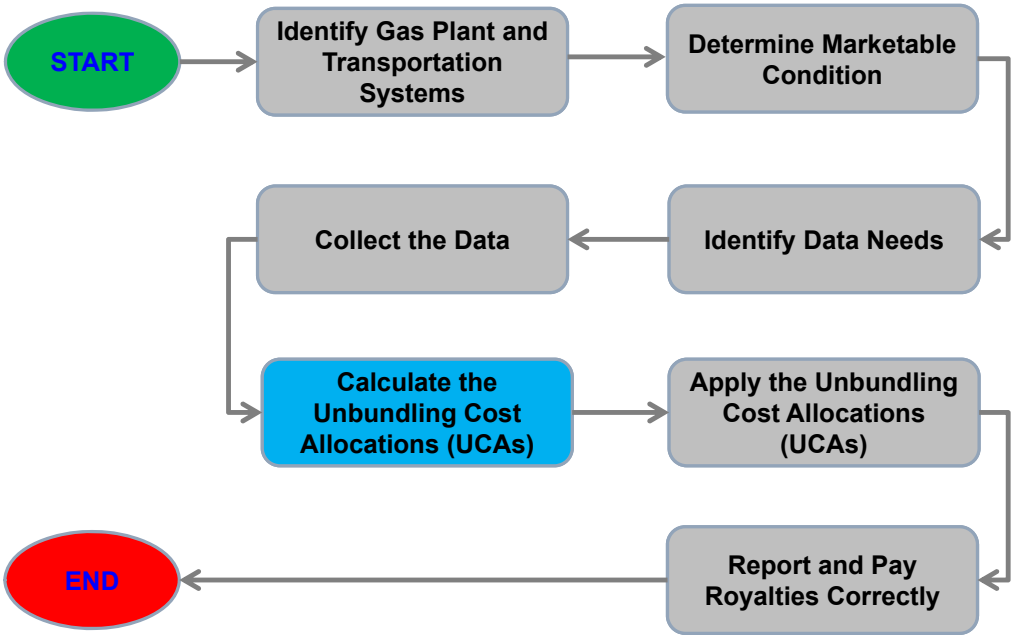
THE UNBUNDLING PROCESS



An Example of the Unbundling Process
(*Collect the Data*)

- **Where does the data come from?**
  - Producer--if you own the plant/system and have reasonable actual costs (NARM situation)
  - Information available on the internet
  - 3rd parties such as plant/system operators
  - Gas Plant Statements

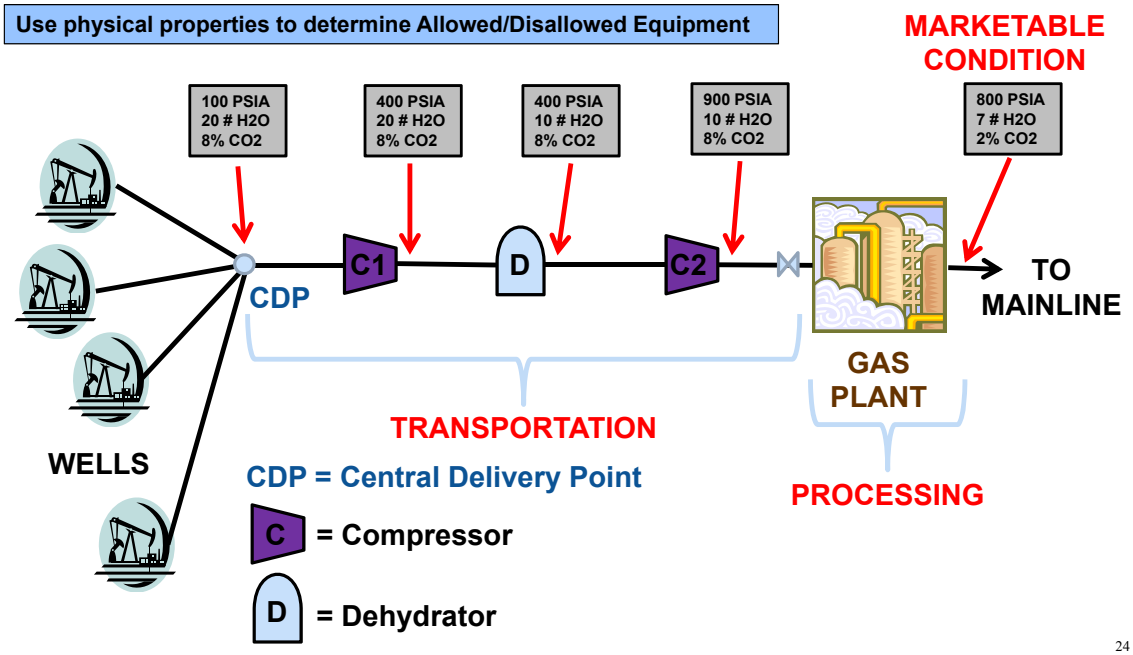
THE UNBUNDLING PROCESS



An Example of the Unbundling Process

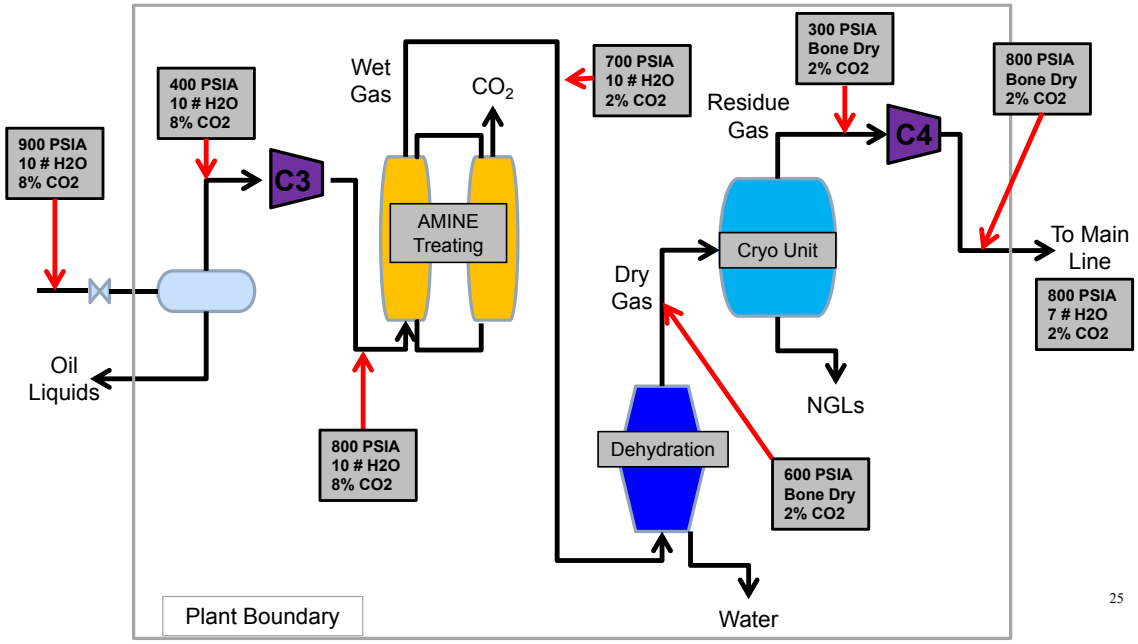
(Calculate Unbundling Cost Allocations)

Use physical properties to determine Allowed/Disallowed Equipment



An Example of the Unbundling Process
(*Calculate Unbundling Cost Allocations*)

Use physical properties to determine Allowed/Disallowed Equipment



An Example of the Unbundling Process
(*Calculate Unbundling Cost Allocations*)

Transportation System

Equipment	Cost (millions of dollars)	Allowed Cost
Compressor 1	15	0
Dehydrator	3	0
Compressor 2	15	1.67*
Pipeline	50	50
Total	83	51.67

* = (1-8/9)*15

Allowed percent = 51.67/83 = 62%

Processing Plant

Equipment	Cost (millions of dollars)	Allowed Cost
Compressor 3	5	5
Amine Treating	2	0
Dehydration	1	0.7*
Cryo Unit	10	10
Compressor 4	5	0
Piping and other allowed equipment	35	35
Total	58	50.7

* = (1-3/10)*1

Allowed percent = 50.7/58 = 87%

Separating Transportation from Processing:

Transportation percent = 83/(83+58) = 59%

Processing Percent = 100 – 59 = 41%

An Example of the Unbundling Process
(*Calculate Unbundling Cost Allocations*)

- Your combined fee is $1.00/Mcf
- Transportation percent = 59%
  - –Transportation fee = $1.00 * 0.59 = $0.59/Mcf
  - –Allowed Transportation fee = $0.59 * 0.62 = **$0.37/Mcf**
- Processing Percent = 41%
  - –Processing fee = $1.00 * 0.41 = $0.41/Mcf
  - –Allowed Processing fee = $0.41 * 0.87 = **$0.36/Mcf**

An Example of the Unbundling Process
(*Calculate Unbundling Cost Allocations*)

BUT WHAT IF YOU DON'T HAVE THE COST DATA?

THE ENGINEERING SOLUTION

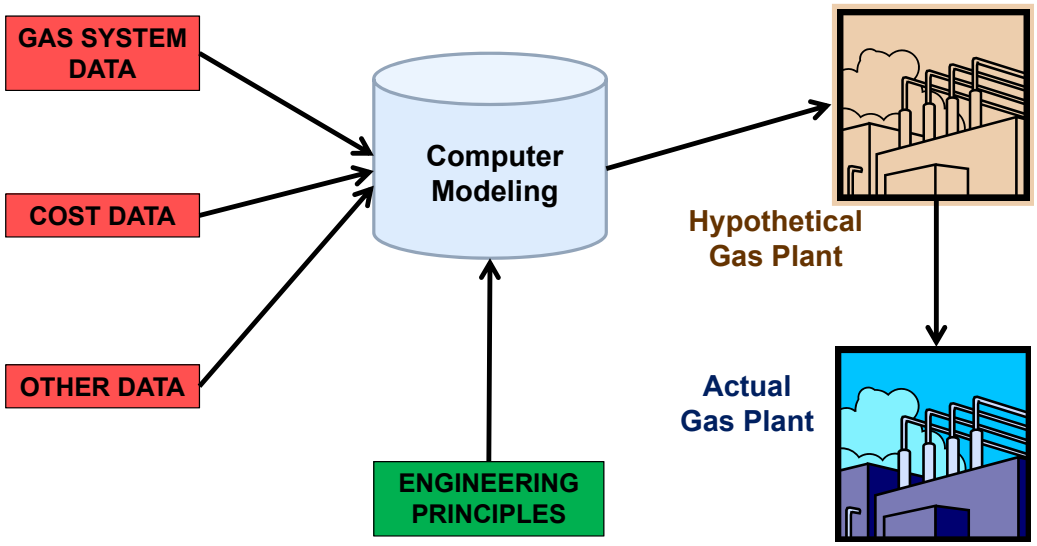
- **Previous Unbundling Efforts have taken an average of 3 years to complete**

- **ONRR is Evaluating an Engineering Solution that uses:**
  - ✓**Industry Accepted Engineering Practices and Data;**
  - ✓**Sophisticated, "Industry Standard" Modeling Tools; and**
  - ✓**Replacement Costs, adjusted for Location and Updated Annually**

- **You can use an Engineering Solution**

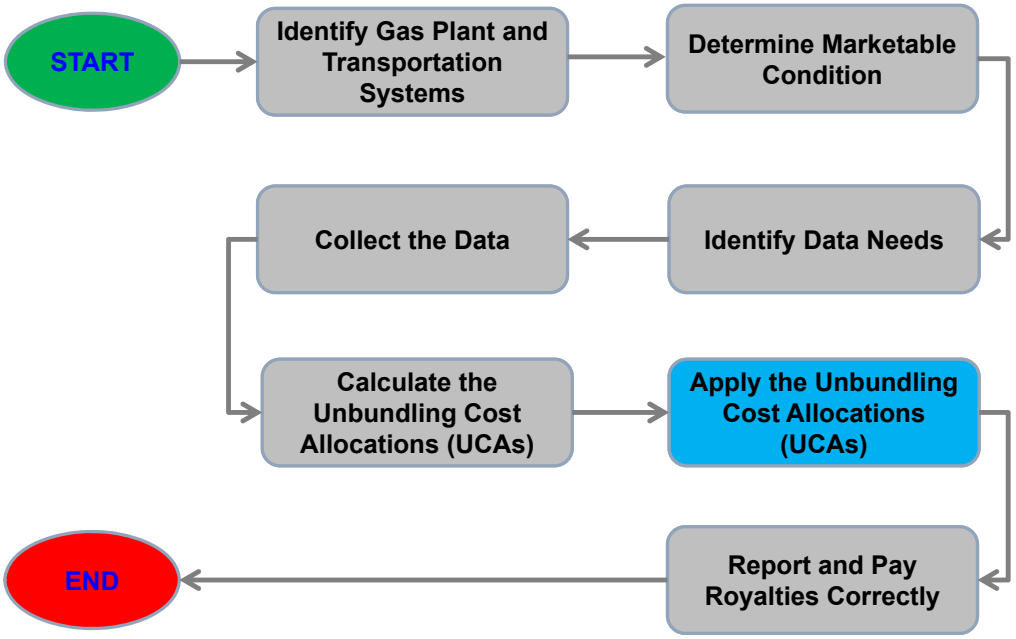
- **An Engineering Solution has some Minimal Data needs:**
  - **Process Flow Diagrams**
  - **Gas Throughput**
  - **Gas Composition**
  - **Inlet and outlet conditions for major process components**

THE ENGINEERING SOLUTION



Industry Compliance • Accurate Revenues and Data • Professionalism & Integrity

THE UNBUNDLING PROCESS



Applying the Unbundling Cost Allocations (UCAs)

After calculating your UCAs, you need to use them in reporting Transportation and Processing Allowances

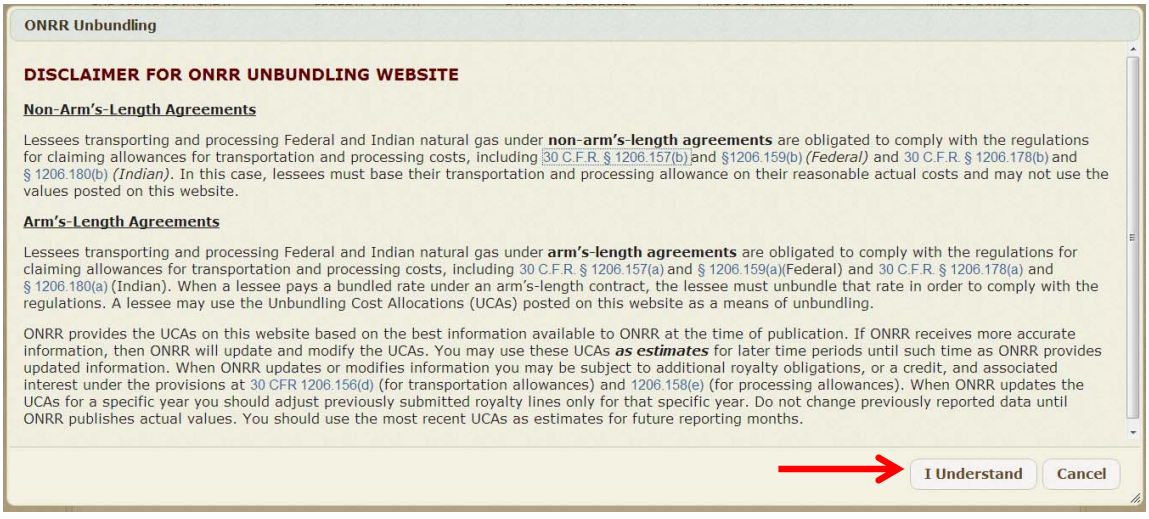
The following example demonstrates using UCAs from the ONRR Unbundling website.

Applying the Unbundling Cost Allocations (UCAs)
(*ONRR Unbundling website*)

The ONRR Unbundling website can be found at:
http://www.onrr.gov/unbundling/default.htm

Applying the Unbundling Cost Allocations (UCAs)
("*Understanding" the Disclaimer*)

To enter the website, you must read the Disclaimer and then select the "I Understand" box



Applying the Unbundling Cost Allocations (UCAs)
(*An Example using the Carlsbad System and Plant*)

ENTERPRISE - CARLSBAD GATHERING SYSTEM AND PLANT

Charges on the Carlsbad system are explicitly indentified by Enterprise for various services including gathering, dehydration, compression and product extraction. Dehydration and compression charges are not allowed. A portion of the gathering and products extraction fees are allowed as specified below. Enterprise bills separately for the James Ranch and Burton Flats compressors; these costs together with any associated fuel are not allowed.

CARLSBAD GATHERING SYSTEM COST ALLOCATION				
YEAR	2004	2005	2006	2007
Allowed Costs	93.40%	85.10%	90.50%	90.00%
Disallowed Costs	6.60%	14.90%	9.50%	10.00%
	100.00%	100.00%	100.00%	100.00%

CARLSBAD PLANT COST ALLOCATION				
YEAR	2004	2005	2006	2007
Allowed Costs	0.00%	0.00%	8.20%	8.20%
Disallowed Costs	100.00%	100.00%	91.80%	91.80%
	100.00%	100.00%	100.00%	100.00%
Processing began in 2006. Allocation does not change until plant is modified.				

Applying the Unbundling Cost Allocations (UCAs)
(*An Example of Sample Fees*)

- 2007 Plant Settlement Statement: Fees Charged

➢ Electrical Compression:	$ 25.00
➢ Gathering/Dehydration:	$300.00
➢ N.M. Processors Tax:	$ 50.00
➢ Product Extraction:	$125.00
➢ Lateral Compression (Burton Flats):	$100.00
	$600.00 TOTAL

Applying the Unbundling Cost Allocations (UCAs)
(*Identifying Fees for Transportation and Processing*)

- 2007 Plant Settlement Statement: Fees Charged

➢ Electrical Compression:	$ 25.00	
➢ Gathering/Dehydration:	$300.00	
➢ N.M. Processors Tax:	$ 50.00	
➢ Product Extraction:	$125.00	
➢ Lateral Compression (Burton Flats):	$100.00	
	$600.00	TOTAL

Processing
Transportation

Applying the Unbundling Cost Allocations (UCAs)
(*Calculating Allowed Processing Fees*)

Allowed Processing Fees

➢ Electrical Compression:	(8.2% x $ 25.00)	=	$ 2.05
➢ N.M. Processors Tax:	(100% x $ 50.00)	=	$ 50.00
➢ Product Extraction:	(8.2% x $125.00)	=	$ 10.25

➢ Total Allowed Processing Fees: $ 62.30

Applying the Unbundling Cost Allocations (UCAs)
(*Calculating Allowed Transportation Fees*)

Allowed Transportation Fees

- Gathering/Dehydration: (90% x $300) = $270.00
- Lateral Compression -- Burton Flats: (0% x $100) = $ 0.00

- Total Allowed Transportation Fees: $270.00

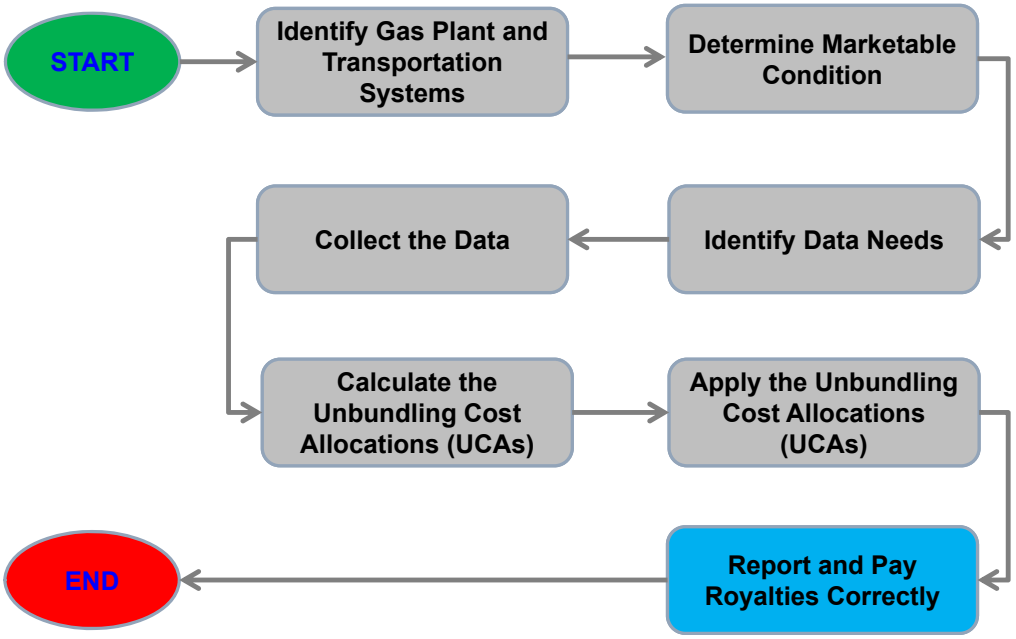
Applying the Unbundling Cost Allocations (UCAs)
(*Total Allowed Fees*)

Total Allowed Fees

- Transportation = $270.00
- Processing = $ 62.50

- Total Allowed Fees = $332.50

THE UNBUNDLING PROCESS



Transportation and Processing Allowance Reporting on ONRR-2014

Transportation Allowance:

$270.00 x 12.5% = $33.75

Processing Allowance:

$62.50 x 12.5% = $7.81

Note: Royalty Rate = 12.5 %

Transportation and Processing Allowance Reporting on ONRR-2014

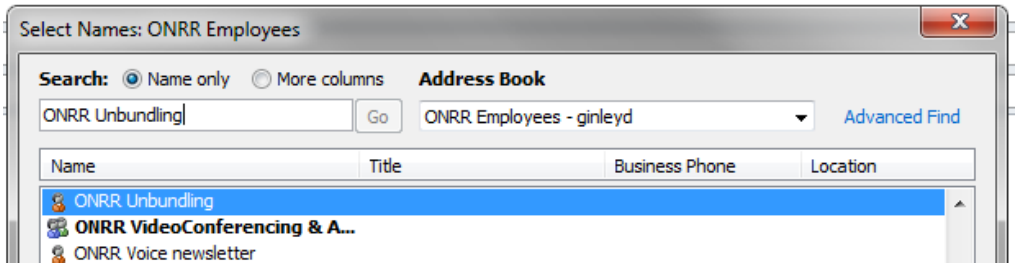
For additional assistance and contact information, go to the following web address:

http://onrr.gov/FM/ReptInfo.htm

Communications – ONRR Mailbox

- Mailbox Exclusively for Questions and Requests Regarding Unbundling

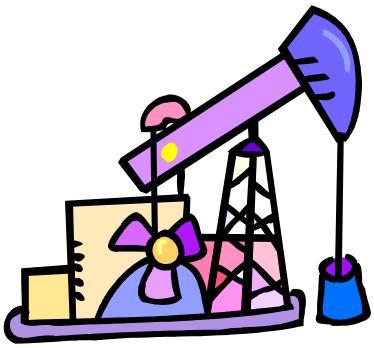
onrrunbundling@onrr.gov



Communications – Unbundling Team

Doug Ginley
Douglas.ginley@onrr.gov
303-231-3845

Linda Shishido-Sheahan
Linda.shishido-sheahan@onrr.gov
303-231-3820



QUESTIONS ?

Data Needed to Calculate Unbundling Cost Allocations (UCAs):

Note: This is not a comprehensive list of data needed to unbundle a transportation system or processing plant. Additional data might be required in order to calculate correct UCAs. ONRR reserves the right to request information that is not present on the list below. The source of each article of information must be correctly documented.

Engineering Data:

System/Plant/Mainline Overview Information:

- List all mainlines at tailgate of plant. For each mainline provide documentation for:
  - Temperature, pressure, water, CO_2 and H_2S content needed to enter the pipeline.

Transportation/Gathering System Data:

- Map or GIS data of transportation system inclusive of:
  - Central delivery points
  - Location of plant(s)
  - Compressor stations
  - Dehydrators
  - Sweetening Units
- For the transportation system provide:
  - GIS data or a list of diameters and lengths of each applicable segment of pipeline.
  - List all compressors upstream of the specified plant, date placed into service, compressor type (centrifugal, reciprocating), and design horsepower.
  - Documentation of the yearly average suction and discharge pressures for each compressor.
  - Easily readable schematics for all compressor stations.
  - Easily readable schematics for all upstream dehydration or sweetening units. Provide inlet and outlet pressures, compositions of gases, water vapor content, hydrogen sulfide content and carbon dioxide content.
  - Provide Depreciation or return on depreciable capital investment for all pieces of equipment.
- Statements documenting gas volumes of field loss and/or fuel use in the transportation system.
- An explanation of the fee charged for transportation/gathering e.g. excess CO_2 or H_2S charges, extra compression charges, separate charges for each trunk line.
- Provide itemized operating expenses, maintenance expenses and overhead expenses.

Gas Processing Plant Data:

- Documentation of when operation began for the Gas Processing Plant.
- List of the owner(s) and operator(s) of the plant and their percentage of interest.
- A detailed Process Flow Diagram (PFD) of the plant with a legend including all compressors and processes performed in the plant.
    - List all compressors in the plant, date placed into service, compressor type (centrifugal, reciprocating), and design horsepower.
    - List of all auxiliary or support equipment not included in the PFD and the process each piece of equipment supports.
    - Provide depreciation or return on depreciable capital investment for all pieces of equipment.
- List of the major improvements to the plant and the year placed in service.
- Documentation of the composition and pressure of the gas entering the plant and sample gas analysis reports. Include hydrocarbon compositions, water vapor content, hydrogen sulfide content and carbon dioxide content.
- Documentation that shows yearly average temperature, pressure, water vapor content, hydrogen sulfide content and carbon dioxide content before and after each stage of compression, separation or treatment of the gas.
- An explanation of the plant's fee charged for processing for each agreement as described below:
- List of joint ownership interest in any fractionation facilities and the percentage of interest.
- An agreement with any applicable fractionation facilities.
- Provide itemized operating expenses, maintenance expenses and overhead expenses.

Contract and Accounting Data:

System/Plant/Mainline Overview Information:

- A list of the names of all transportation/gathering systems entering and exiting the plant.
  - Include owner, and operator, and their percentage of interest in the system(s).
- A list of producers (shippers) who shipped gas through each transportation/gathering system(s).
- A list of producers (shippers) who processed gas through the plant.
- List of meter numbers and names along the transportation systems upstream of the plant.

Transportation/Gathering System Data:

- Statements documenting gas volumes of field loss and/or fuel use in the transportation system.
- An explanation of the fee charged for transportation/gathering for each agreement as described below:
  - Cross reference any specific transportation/gathering fees on the transportation/gathering invoice(s) to equipment on the schematic where applicable.
  - Two transportation/gathering agreements (contracts) including amendments, representing customers transporting/gathering large gas volume.
  - One transportation/gathering agreement (contract) including amendments, representing a customer transporting/gathering small gas volume.
  - Transportation/gathering invoices applicable to the agreements provided above inclusive of gas volumes, meter name and number, transportation/gathering rate(s) and transportation/gathering charged.