Subcommittee on Energy and Mineral Resources

Doug Lamborn, Chairman

Hearing Memorandum

December 7, 2015

To: All Subcommittee on Energy and Minerals Members

From: Subcommittee on Energy and Minerals Staff (x5-9297)

Subject: Oversight hearing on *"Ensuring Certainty for Royalty Payments on Federal Resource Production"*

The Subcommittee will hold an oversight hearing on *"Ensuring Certainty for Royalty Payments on Federal Resource Production"* on **December, 8, 2015 at 10:00 a.m. in Room 1324 Longworth House Office Building.** This hearing will focus on the Office of Natural Resources Revenue's (ONRR) proposed rule concerning the valuation of produced federal onshore oil, natural gas, and coal for royalty purposes, as well as ONRR's reinterpretation of existing regulations as to when produced natural gas is in marketable condition.

Policy Overview

- ONRR's reinterpretation of the treatment of bundled contracts has confused and complicated the determination of a natural gas producer's rightful deductions, and promoted uneconomic conditions, which have led to layoffs and potential bankruptcies.

- On January 6, 2015, ONRR proposed a rule that would make sweeping revisions to the methodologies behind royalty valuation. ONRR projects the rule will cost industry $80 million, whereas industry places the cost in the hundreds of millions.

- ONRR's proposed valuation reform rule ignores the realities and economics of natural resource production and would grant absolute discretion to ONRR auditors.

- ONRR's net-back provision within the valuation rule for non-arm's-length coal transactions is an unwarranted expansion of ONRR's jurisdiction and presents companies with an unworkable means of calculating the value of their products.

Witnesses Invited

Mr. Dan R. Bucks
Former Montana Director of Revenue
Milwaukee, WI

Mr. Jonathon Downing
Executive Director, Wyoming Mining Association
Cheyenne, WY

Ms. Karin Foster
Executive Director, Independent Petroleum Association of New Mexico
Albuquerque, NM

Mr. Gregory Gould
Director, Office of Natural Resource Revenue, U.S. Department of the Interior
Washington, DC

Ms. Judith Matlock
Partner, Davis Graham & Stubbs
Denver, CO

Background

Under the Mineral Leasing Act,[1] the royalty rate for leasing onshore federal land for the production of coal, oil and natural gas is 12.5 percent – in turn, onshore production alone has returned roughly $20 billion in royalty payments for the American people over the past six years.[2] Although the royalty rate has been set at a constant level for over 90 years, the calculations of the royalty payment itself is complex. Indeed, much like income tax payments, valuing royalty owed involves a number of deductions; and like the Internal Revenue Service, the Office of Natural Resources Revenue (ONRR) is tasked with determining whether royalty payments are correct. Failure to make accurate royalty payments can subject a royalty payor to ONRR audits and lead to monetary penalties. As such, it is in the interest of payors to earnestly attempt to comply with all reporting laws, policies and guidance.

In 2007, Secretary Kempthorne appointed a Subcommittee on Royalty Management to examine, among two other charges, whether "existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure the Minerals Management Service receives the correct amount."[3]

The Subcommittee returned over 100 suggestions for improvements to the Minerals Management Service's (the predecessor to ONRR) royalty program. Three of those recommendations were: 1) to publish "guidelines to address the cost-bundling issue, and to facilitate the calculation of gas transportation and gas processing deductions"; 2) to "publish proposed revisions to the gas valuation regulations;" and 3) to "review and revise and implement the regulations and guidance for calculating prices used in checking royalty compliance for solid minerals, with particular attention to non-arms-length transactions."[4]

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[1] 30 U.S.C. § 226(b)(1)(A); 30 U.S.C. § 207(a).
[2] Calculated by adding the *Reported Royalties* of coal, gas, NGL, and oil for *Sales Years* 2009 to 2014 from http://statistics.onrr.gov/ReportTool.aspx.
[3] Royalty Policy Committee, Subcommittee on Royalty Management, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf," at viii (Dec. 17 2007).
[4] *Id.* at 73.

While these three recommendations serve as the catalyst for ONRR's actions regarding unbundling and the valuation reform rule for natural gas, oil, and coal. ONRR has implemented these recommendations through arbitrary actions, which injects uncertainty and difficulty into the valuation of produced resources for royalty purposes.

Unbundling Increases Uncertainty in the Natural Gas Market

Over the past few years, the Office of Natural Resources Revenue started enforcing its reinterpretation of the deductible allowances for transportation and processing fees for natural gas producers. This reinterpretation is being applied retroactively, forcing producers to account up to seven years in the past for a regulation they could not have known they would be forced to comply with. This unjustifiable position has already cost tens of millions to producers in New Mexico[5] – as they were deemed the "proverbial 'guinea pigs'"[6] – and will be expanded to producers in other states, notably Colorado, Wyoming and Utah.

The reinterpretation revolves around the "marketable condition" rule. In effect for decades, but first promulgated in 1988, the marketable condition rule requires lessees of federal land to put their produced product in a state "sufficiently free from impurities and otherwise in a condition that . . . will be accepted by a purchaser under a sales contract typical for the field or area."[7] When the 1988 rule was promulgated, the primary purchasers of natural gas were pipelines, and as such, gas was purchased at the wellhead. However, this changed in 1992, when pipelines were transformed into open-access transporters.[8] Producers could now sell directly to the end users, distributors, and merchants; but, in order for natural gas to reach these customers, the producers or their purchasers will contract with service providers to transport and process the gas.[9] Frequently, these contracts "bundle" together transportation and processing fees into a single line item, without providing specific costs for processes like dehydration, or compression.

Post transformation of the natural gas market, the Minerals Management Service (MMS), permitted producers to deduct those bundled contract costs from the gross proceeds for the purposes of calculating royalties. These deductions were justified by two memos in 1995 and 1996, as well as precedent set by the Department of Interior demonstrating a historical reluctance to unbundle costs "when such separation is administratively difficult."[10]

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[5] *See* James Fenton, *'Unbundling' regulation on royalties frustrates oil and gas industry*, THE DAILY TIMES, April 5, 2015 ("Farmington independent gas company DJ Simmons Inc. is struggling with the new guidelines, which have caused the company more than $100,000 in attorney's fees and added staff time in a deflated market. One of the company's leases was audited by the ONRR two years ago, which is when John Byrom, DJ Simmons president and CEO, first learned of the new guidelines.").

[6] Independent Petroleum Association of New Mexico, Comments on Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, May 8, 2015.

[7] 30 CFR § 206.151

[8] *See Independent Petroleum Assoc. of America v. DeWitt*, 279 F.3d 1036, at 1038 (D.C. Cir. 2002).

[9] *Id.*

[10] *Id.* at 1042 (discussing how prior to Order 636, Interior had permitted deductions for marketing costs when such costs were bundled with transportation costs).

However, following several cases involving the deductibility of processing fees for coalbed methane, the ONRR issued a "Dear Reporter" letter in 2010 that suggested certain bundled costs were no longer – and had never been – deductible.[11] The letter shocked industry, as there had been no prior indication that bundled costs would no longer be deductible expenses. In essence, the 2010 letter moved marketable condition away from the wellhead, and determined that produced natural gas for royalty's sake needed to be in a condition suitable for distribution on a mainline pipeline.

ONRR's reinterpreted guidance for bundled deductions burdens producers with an administratively difficult and costly process for determining the value of their product. To unbundle, providers look to Unbundling Cost Allocations (UCAs), which provide determinations for what percentage of a transportation and processing service provider's bundled costs are to put the natural gas in marketable condition, and therefore non-deductible. Producers seeking to comply with ONRR's reinterpretation have three choices for unbundling the contractual fees: 1) calculate UCAs on the operator's own, 2) use the UCAs posted to ONRR's website, or 3) take no deductions at all. However, this is a false choice, as each methodology is fraught with problems.

The first choice, calculating the UCAs on an operator's own, has proven difficult due to inaccessibility of information. If an operator chooses this method and sought to calculate the most exact unbundled allowance, he would need to obtain confidential and proprietary information belonging to the owners of gathering and processing facilities. Since those owners represent a competing business interest, this is not viable, as it would undermine those owners' business interests. Therefore, operators who choose to calculate their own UCA must estimate the unbundling allowance. This is a costly and time-consuming process – and may still result in penalties – and has pushed smaller operators to financial extremes.[12]

The second choice, using ONRR's own UCAs, presents operators with the challenge of dealing with uncertainty. A visitor to ONRR's unbundling website must read a disclaimer, and click "I understand" before they are allowed access to the UCAs. This disclaimer provides in part that "the UCAs on this website [are] based on the best information available" but that ONRR "will update and modify the UCAs" "[i]f ONRR receives more accurate information."[13] "When ONRR updates the UCAs for a specific year [operators] should adjust previously submitted royalty lines," as operators "may be subject to additional royalty obligations . . . and associated interest."[14] Essentially, there is no certainty that once a royalty payor follows ONRR's own suggested UCAs they will be free from future audits and associated penalties.

The final choice, while easiest and most certain for producers, would result in the highest costs of the three methods. As previously mentioned, the royalty rate for natural gas is statutorily set at 12.5% - and the federal government has received this rate calculated on the

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[11] *See* Oct. 6, 2010 Dear Reporter Letter, RE: GUIDANCE ON VALUING GAS FOR ROYALTY PURPOSES – TRANSPORTATION SYSTEMS AND PROCESSING PLANTS – ONSHORE FEDERAL LEASES, *available at* http://onrr.gov/unbundling/pdf/DRL_Transportation_Systems_and_Processing_Plants_October_6_2010.pdf.
[12] *See* James Fenton, *'Unbundling' regulation on royalties frustrates oil and gas industry*, THE DAILY TIMES, April 5, 2015.
[13] Disclaimer for Unbundling Website, http://onrr.gov/unbundling/.
[14] *Id.*

gross proceeds of the natural gas produced from the lease. By disallowing the deductions, ONRR unilaterally changes the effective royalty rate upwards – contrary to the lease's terms.

In essence, the first two options create uncertainty as to the proper calculations, thus potentially exposing the payor to penalties. The third option is a *de facto* royalty rate increase for ONRR in violation of the statute.

These three methods represent the difficulty in complying with ONRR's reinterpretation of bundled deductions. Had ONRR proceeded with a proper rulemaking, operators would have been able to appropriately comment and affect how ONRR would enforce unbundling, and – more importantly – prepare for unbundling. However, ONRR took a unilateral path, and blindsided the regulated community with an interpretation that muddled the calculation of royalties with uncertainty and arbitrary calculations. Furthermore, ONRR now has a chance to clarify the marketable condition rule in the valuation reform rule and to promulgate regulations pertaining to unbundling, yet, ONRR has confusingly chosen not to do so.

Proposed Rule for Valuation Reform Grants Absolute ONRR Discretion and is Unworkable

ONRR issued a proposed rule to reform the valuation of produced resources on federal land on January 6, 2015.[15] This rule, ONRR asserts, reflects "an effort by ONRR to update its royalty valuation regulations to, among other things, simplify processes and provide early clarity regarding royalties owed."[16] Specifically, ONRR contends the proposed rule will: (1) "offer greater simplicity, certainty, clarity, and consistency in product valuation;" (2) "be more understandable;" (3) "decrease industry's cost of compliance and ONRR's cost to ensure industry compliance;" and (4) "provide early certainty to industry and ONRR that companies have paid every dollar due of oil, gas, and coal produced from Federal [and Indian] leases."[17] ONRR also recognizes that "even with the changes outlined in this rule, royalty valuations will continue to be complex, and markets for oil, gas, and coal will continue to evolve."[18]

Although ONRR admits valuation is a complex process, this rule further complicates that process, defeating the premises used by ONRR to justify its rulemaking. In fact, the rule hinders certainty and consistency, confuses the calculation of the value of produced resources, increases costs for industry, and will likely result in decreased revenue to the federal government. Furthermore, it is an expensive rulemaking, as ONRR predicts the rule will cost industry $80 million.[19] However, industry pegs the price at much higher – indeed, the Council of Petroleum Accountants Societies believes the rule could exceed $100 million for the oil and natural gas industries alone.[20]

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[15] Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, 80 Fed. Reg. 608. (Jan. 6, 2015) (to be codified at 30 C.F.R. pts. 1202 and 1206).
[16] 80 Fed. Reg. at 609.
[17] Office of Natural Resources Revenue, Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform: Abstract.
[18] 80 Fed. Reg. at 609.
[19] 80 Fed. Reg. at 641.
[20] Council of Petroleum Accountants Societies, Comment on Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, May 8, 2015.

Proposed Rule's Default Methodology Grants ONRR Absolute Discretion and is Unrealistic

For all three natural resource products – coal, natural gas, and oil – ONRR proposes a new method for determining the value of the product. This "default" method permits ONRR the ability to determine the value of a lessee's product if one of the following conditions occurs:

1) "There is misconduct by or between the contracting parties";
2) A lessee "ha[s] breached [his] duty to market . . . for the mutual benefit of [his]self and the lessor by selling [his] product unreasonably low"; and
3) "ONRR cannot determine if [a lessee] properly valued [her] [product] . . . for any reason, including but not limited to, her or her affiliate's failure to provide documents."[21]

These extremely broad provisions permit ONRR the ability to value a lessee's products for nearly any reason possible. ONRR defines *misconduct*, as understood in the first trigger to include "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior regardless of the mental state of the lessee or any individual employee by, or associated with the lessee."[22] In other words, mere mistakes by an employee could subject a lessee to having its product valued by ONRR under criteria, which include "[a]ny information ONRR deems relevant regarding the particular lease operation or salability of the gas."[23]

The second provision grants discretionary authority to ONRR to determine whether a lessee has breached its duty to market if a sales price is "unreasonably low."[24] ONRR defines "unreasonably low" as being "10-percent less than the lowest other reasonable measures of market price, including but not limited to prices reported to ONRR for like-quality [products]."[25] Likewise, ONRR may consider deductions, such as transportation and processing, too high, if they are 10-percent "higher than the highest reasonable measures."[26] When exercising its discretion, "ONRR may consider any information that shows a price appears unreasonabl[e], and, thus, is not an accurate reflection of fair market value."[27]

The unreasonableness standard promoted by ONRR ignores market and contract principles. For instance, the proposed unreasonableness determination ignores that while the federal royalty interest is 12.5%, the lessee's share of the revenue stream is much higher, and therefore, lower prices would adversely affect the lessee's profits more than ONRR's. Similarly, the proposal also fails to consider that prices may be low for a myriad of reasons, such as the quality of the produced product. As for the deductions, ONRR fails to consider geographic distances that would affect a lessee's transportation costs. These are but a few of the instances

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[21] *See e.g.* 80 Fed. Reg. at 656 (proposed section 1206.143(c) providing the circumstances in which the default provision may be invoked for natural gas).
[22] 80 Fed. Reg. at 621.
[23] *See e.g.* 80 Fed. Reg. at 656 (proposed section 1206.144(f)).
[24] *See e.g.* 80 Fed. Reg. at 664 (proposed section 1206.253(c)).
[25] *Id.*
[26] 80 Fed. Reg. at 624.
[27] 80 Fed. Reg. at 621.

ONRR fails to consider in its rule, but they demonstrate ONRR's ignorance of the economics of resource production.

Finally, the third provision, which permits the "default" methodology for a failure to provide documents, represents a burden that some lessees may not be able to overcome. For instance, auditors may "request documents that are not the lessee's documents and that a lessee does not have any legal right to obtain."[28] Take for instance the difficulty with which lessees of natural gas are unable to obtain for the purpose of unbundling costs associated with transportation and processing fees. Were ONRR to request these documents and the lessee failed to provide them, ONRR would set the value of the natural gas produced by the lessee.

Thus, the "default" methodology grants ONRR the unilateral right to adjust a lessee's calculated value to whatever value ONRR believes is adequate, based on "any information" deemed relevant by ONRR. It ignores the realities of markets, and a lessee's desire for profit.

Unworkable Net-Back Provision for Non-Arm's-Length Coal Transactions Expands ONRR's Jurisdiction

Most federal coal is currently mined out of the Powder River Basin (PRB), which exists in Montana and Wyoming.[29] About two thirds of the coal produced in the PRB is sold at arm's length – meaning "sold on the open market to other coal companies or consumers"; while one third is dispersed through non-arm's-length (NAL) transactions.[30] For NAL transactions, the coal is "used by the producing company or sold to affiliated or parent companies."[31]

Arguably, NAL transactions for coal are harder to value, as non-competing interests are at play. As such, the ONRR, and the MMS before it, established a benchmark system, which utilizes five separate points to determine the value of coal produced. The five benchmarks, in order of consideration, are as follows:

> 1) "The gross proceeds accruing to the lease pursuant to a sale under its non-arm's-length contract . . . provided that those gross proceeds are within the range of the gross proceeds derived from, or paid under, comparable arm's-length contracts";
> 2) "Prices reported for that coal to a public utility commission";
> 3) "Prices reported for that coal to the Energy Information Administration of the Department of Energy";
> 4) "Other relevant matters including, but not limited to, published or publicly available spot market prices, or information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability [*sic*] of certain types of coal";
> 5) Lastly, "a net-back method or any other reasonable method shall be used to determine value."[32]

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[28] *See* Judith Matlock, Comment on Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform, May 8, 2015.
[29] Headwaters Economics, *An Assessment of U.S. Federal Coal Royalties*, at Table 5 (Jan. 2015).
[30] *See* U.S. Energy Information Administration, Annual Coal Report 2013, Table 8.
[31] *Id.*
[32] 30 C.F.R. 1206.257(c)(2).

The majority of NAL transactions are valued under the first or fourth benchmarks, and producers have found the benchmark method to be successful and make sense.[33]

However, ONRR in the proposed rule asserts the benchmarks in "non-arm's-length or no sale situations have proven difficult to use in practice."[34] Under this finding, ONRR proposes to eliminate the benchmark system for NAL transactions entirely, and implement a net-back method, which had been the benchmark of last resort to determine the valuation of coal.[35]

This proposed net-back method for NAL transactions represents a broad regulatory expansion for ONRR, as it grants ONRR the authority to assess the royalty value of coal, based on the electricity generated by such coal.[36] Essentially, a lessee, to value his coal in which the first arm's-length sale occurred with the distribution of electricity, would be required to deduct from the value of the electricity the transmission and generation costs, as well as the costs associated with transportation and washing.[37] This proposal falsely assumes a similarity of markets between coal and electricity, and ignores ONRR's statutory authority to assess royalty on only the "value of coal" – not the value of electricity.[38]

Furthermore, the same problems faced by the natural gas industry tasked with unbundling would manifest in the realm of coal. Much like the arbitrary disallowance of CBM deductions to conventional natural gas, ONRR seeks to apply geothermal deductions to the electricity generated by coal.[39] ONRR fails to provide any rationale for this determination, nor does it provide any guidance as to how these values are to be determined.

Thus, the proposed net-back methodology expands ONRR's jurisdiction beyond its statutory duty, and creates an arbitrary system that will hinder honest attempts to value coal through NAL transactions.

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[33] *See e.g.*, Wyoming Mining Association, Comments on Office of Natural Resources Revenue (ONRR) Proposed Rule to Amend Federal and Indian Coal Valuation Regulations, at 2, May 8, 2015.
[34] 80 Fed. Reg. at 628.
[35] *Id.*
[36] *See id.*
[37] 80 Fed. Reg. at 664 (proposed section 1206.252(b)).
[38] 30 U.S.C. § 207(a).
[39] *See* 80 Fed. Reg. at 664 (proposed section 1206.252(b)(1) "if applicable, transmission and generation deductions" will be determined under 1206.353 and 1206.352, which are both geothermal regulations).