Fair Return and Value Subcommittee

Fair Return and Value Subcommittee
Oil and Gas Payor Handbook
February 28, 2018

1. Background

The Secretary of the Interior has been granted authority by Congress to inspect, collect, account for and audit oil and gas royalties from lease sites on Federal and Indian lands.[1] This authority has been delegated to the Office of Natural Resources Revenue (ONRR) which "collects, accounts for, and verifies natural resource and energy revenues due to States, American Indians, and the U.S. Treasury."[2] In order to assist Federal and Indian oil and gas lessees, the Minerals Management Service[3] published the first Oil and Gas Payor Handbook (Payor Handbook) in 2000. The Payor Handbook was last updated in February of 2001 and since then a variety of decisions have been announced pertaining to the payment of royalties as well as new regulations and statutes. Due to the need to update the Payor Handbook to reflect current law, ONRR started reviewing it with the idea of revising the Handbook at about the same time as the formation of the Royalty Policy Committee.

2. Payor Handbook Outline Review and Suggestions

Record Keeping and Information Protection

- ONRR should alert payors to how ONRR protects their information
- ONRR should alert payors to the FOIA process and ways that ONRR protects proprietary data in that process

Definitions Section

- ONRR's definitions have legal significance and ONRR should link the definitions to the CFR.

Valuation Basics

- Point of Royalty Settlement
    - Terminology can be confusing for some producers. For example, Point of Royalty Settlement can be confused with allocation meter, FMP, point of measurement, or sales meter.

- Beneficial Use
    - ONRR may need to reevaluate this section in light of new BLM regulations.

- Marketable Condition
    - Add examples

[1] 29 USCA § 1701 and § 1711
[2] https://www.onrr.gov
[3] The Minerals Management Service was the predecessor to ONRR

- Because the Payor Handbook was published before the *Devon* decision, ONRR should address marketable condition and unbundling here at a high level and reserve the more nuanced items for the appropriate gas and oil sections.
- ONRR should add a section on the lessee's duty to market production separate from, but linked to, the marketable condition section.

- Quantity/Quality
  - ONRR should incorporate wet versus dry gas reporting and add sample calculations or link to the Minerals Revenue Reporter Handbook

Federal Oil Valuation

- Valuation Determinations
  - ONRR should distinguish between guidance and determinations by adding a table that can be copied into or linked to for each commodity

Oil Transportation Allowances and Adjustments

- Oil Differentials
  - ONRR should research industry terminology relating to differentials to ensure readers understand what is properly deductible

- Transportation Allowances without arm's-length contracts
  - Update with recent ONRR training examples

Federal Gas Valuation

- Unbundling and UCAs
  - Section may move from this location

- Percentage of Index and/or Percent of Retainage Example
  - ONRR is planning on creating a POP Contracts Dear Reporter Letter that will address some of these issues.

- Tariff (Transportation and Processing)
  - only applies to transportation, not processing

- Guidance for pipeline fuel, gas plant fuel, unbundling UCA
  - ONRR should separate into the following sections:
    - Fuel (to include all categories of fuel—pipeline, gas plant, etc.)
    - Unbundling
    - UCAs
  - ONRR should make a distinction between beneficial use fuel, plant fuel, and pipeline fuel.
  - ONRR incorporate electricity within the UCA section of the Handbook.

Indian Oil and Gas

- ONRR is planning to separate the Indian Oil and Gas section into its own Handbook. It will have unique sections as to Indian payors (Major portion, e.g.) along with sections identical to those provisions in common with general Federal Oil and Gas royalty requirements.

- Fiduciary Trust responsibilities
  - Links should direct users to the source material used for the presentations
  - Add history
  - Add Indian Mineral Development Act (IMDA) agreements
  - Add non-standard lease section

- Indian Dual Accounting and Major Portion Sections:
  - Add detailed, comprehensive examples with reporting
  - ONRR should clearly instruct Industry on timing surrounding Indian gas reporting
  - ONRR should include sample lease language
  - ONRR should incorporate text, visuals, and sample problems into the Handbook to accommodate different styles of learning.

- Major Portion
  - ONRR should add information on lease language
  - ONRR should add a map of the Index Zone areas in the gas section
  - ONRR should add a table illustrating Indian form filing requirements.

3. Recommendations

The recommendations with regard to updates to the Payor Handbook are:

- The Department of Interior should create separate Federal and Indian Payor Handbooks.
- The Department of Interior should engage users of the Payor Handbook to support ONRR in the re-write of the Handbook.
- The Department of Interior should invest in a process by which 'evergreen' Handbooks can be created and updated as regulations change.

Fair Return and Valuation Committee

Index Pricing Working Group

Summary Recommendation

The repealed 2017 Federal valuation rule ("Valuation Rule") included an index pricing provision for Federal gas production. While energy companies generally supported the concepts of an index price, the specific price provisions contained within the Valuation Rule were not widely supported due to concerns that (1) the highest reported price was unachievable and reflected index points not representative of how the gas was actually marketed; (2) transportation cost deductions were unreasonably low; and (3) the resulting price could only be used for non-arms-length sales types.

The Index Pricing Working Group ("IPWG") is charged with exploring the potential to make recommendations for an index price that addresses the issues associated with the index pricing provision in the repealed Valuation Rule and more effectively achieves a simple, certain, clear and concise index price solution.

The IPWG noted the relative administrative ease involved with use of the 2000 Indian Gas Valuation Rule, and its recommendation generally relies on that approach. It was also noted within IPWG discussions that the adoption of a simplified index price has the potential to address many of the separate issues regarding "marketable condition" currently consuming significant resources.

RECOMMENDATION: Pursue rulemaking to define simplified index price rules for Federal gas. Key factors to be addressed by this rule would be:

- A standardized average single (per defined geographic area) price acceptable to both industry and DOI/ONRR
- Calculated (by ONRR) from generally accepted index price publications or other acceptable market-sensitive source
- Apply price to wellhead (or royalty measurement point) MMBTUs
- Incorporate reasonable geographically sensitive transportation deductions
- Apply price to all Federal gas sales types

Additional factors for consideration in the rulemaking process:

- Should the utilization of the price be mandatory or optional by payors?
- Should the "bump" approach of Indian Alternate dual accounting be utilized?

Fair Return and Value Committee
Marketable Condition Work Group
February 12, 2018

1. Background on Marketable Condition

A lessee is required to put gas into marketable condition once at its own expense. ONRR 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 purchase under a sales contract typical for the field or area.” 30 C.F.R. 1206.151 (federal gas), 1206.171 (Indian gas). When raw or wet gas is produced in the field, then travels by pipeline to a gas processing plant, where the heavier components are extracted from the wet gas stream as liquids, and the remaining dry or residue gas is delivered into a mainline pipeline, ONRR uses the requirements the mainline pipeline imposes for entry into its pipeline as the measure of marketable condition. Courts have affirmed ONRR’s use of mainline pipeline requirements as the measure of marketable condition for residue gas.

To meet a mainline pipeline’s requirements, a lessee may be required to compress it gas to a higher pressure, dehydrate the gas to reduce its water content, and “sweeten” the gas by reducing its carbon dioxide (CO_2) and hydrogen sulfide (H_2S) content. Often, a lessee does not incur or pay a separate fee to compress, dehydrate, and sweeten its gas. Instead, a pipeline transporting gas from the field to the processing plant may provide not only transportation services, but also compress and dehydrate the gas for a single fee that covers all its services. And a processing plant may not just process the gas to extract liquids, but also compress, dehydrate, and sweeten the gas for a single fee that covers all its services. In calculating and paying royalties, a lessee may not deduct the costs to compress, dehydrate, and sweeten its gas as necessary to put the gas into marketable condition, but it may deduct transportation and processing costs, subject to certain limits. As a result, a lessee must allocate the costs or fees it pays for services rendered between the field (or royalty measurement point) and the tailgate of a processing plant between non-deductible costs to put gas into marketable condition and deductible costs for transportation and processing. ONRR and industry frequently disagree on the need to allocate costs as well as on acceptable methods for allocation.

2. Compression Required for Marketable Condition or Otherwise

a. **<u>Three disputes</u>.** For at least three reasons, ONRR and industry currently disagree on the compression a lessee must provide at its own expense to put gas into marketable condition:

- **Is boosting residue gas part of the marketable condition requirement or a separate requirement?** ONRR interprets its regulation on compressing or “boosting” residue gas to mean that even if a lessee carries the full cost to meet the pressure requirements for marketable condition before its gas enters a processing plant, the lessee still must pay the full cost to compress or boost residue gas at or after the plant. Industry argues that in many instances

ONRR's interpretation of its regulation requires a lessee to pay the full cost to compress its gas twice through the same pressure range when it should have to pay the full cost only once.

- **Achieve marketable condition or sum to marketable condition?** ONRR does not allow a lessee to deduct any compression costs as gas moves from upstream to downstream until the gas reaches (or "achieves") the pressure requirement of a mainline pipeline, and then also disallows the cost to compress or boost residue gas. Industry argues that at most it must pay the full cost to compress its gas once from the pressure in the field to marketable condition, but if it compresses the gas more than once through any portion of the pressure range between the royalty measurement point and the mainline pipeline, it may choose which compression to deduct and which compression to not deduct to meet its marketable condition requirements.

- **Compression needed to put NGLs into marketable condition?** A pipeline that runs from the field to a processing plant may compress the raw or wet gas stream. At the processing plant, liquids are extracted from the wet gas stream, resulting in residue gas and natural gas liquids (NGLs). In reporting and paying royalties, the lessee allocates its transportation cost or fee between residue gas and NGLs, then deducts separately from residue gas value and NGL value the transportation fee, except that portion of the fee attributable to compression and dehydration needed to put gas into marketable condition. Even though the mainline pipeline only carries the residue gas to market, ONRR uses that pipeline's pressure requirements to determine the non-allowable portion of the transportation fee for both residue gas and NGLs. Industry argues that the mainline pipeline pressure requirements may be relevant to determine the non-allowable portion of the transportation fee for residue gas, but not for NGLs, as NGLs are delivered into a different pipeline with a much lower pressure requirement.

b. <u>Analysis of boosting dispute and recommendation</u>.

ONRR's regulation on boosting residue gas applies only to federal gas. It currently reads:

> (b) A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, <u>but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 CFR part 206.</u> In those situations where a processing plant processes gas from more than one lease, only that proportionate share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free.

ONRR interprets and applies this regulation to require a lessee to pay the full cost to compress or boost residue gas, regardless of whether the lessee has otherwise met the pressure requirements for marketable condition. Also, ONRR has not recognized any exception in part 206 or elsewhere to date. Industry disagrees with ONRR's interpretation and application of the boosting regulation for several reasons:

- The language on boosting, when viewed in the content of paragraph (b) and the section and part in which paragraph (b) appears, speaks to royalty-free use of gas, not the costs of capital, operation, and maintenance of a booster compressor.

- The only rationale that supports disallowance of a booster compressor is the lessee's obligation to put gas into marketable condition at its own expense. If ONRR disallows a deduction for the capital, operation, and maintenance of a booster compressor, it should allow upstream compression costs covering the same pressure range as the booster compressor, as a lessee must put gas in marketable condition only once.

- ONRR cannot apply a regulation that includes exception language as if there is no exception. There is an exception that allows a transportation deduction for "supplemental compression" in 30 C.F.R. 1206.157(f)(9). Supplemental compression, though not defined in the regulations, is any compression beyond that needed to put gas into marketable condition once.

- While the regulation on boosting residue gas applied to both federal and Indian gas from 1942 to 1999, in 1999 ONRR amended its Indian gas valuation regulations, and deleted any reference to boosting as a unique type of compression that must be disallowed regardless of whether a lessee has already met the requirements for marketable condition.

ONRR's interpretation and application of the boosting regulation may increase a lessee's royalty obligation, and hence revenues to the federal government, but:

- It requires lessees to allocate more transportation and processing fees between allowable and non-allowable deductions than would be the case if the boosting regulation was repealed and boosting residue gas was treated just like every other form of compression. Each cost allocation is difficult, expensive, and subject to dispute.

- It generates numerous appeals to ONRR's Director, the Interior Board of Land Appeals, and federal courts. These appeals may continue for a number of years absent resolution of the issue through new rulemaking.

- If this matter is left for resolution though the courts and industry ultimately prevails, lessees may be entitled to amend their royalty reports to lower their royalty obligations for the six preceding years, at significant administrative cost to both ONRR and industry, as well as loss of revenues to the federal government.

Recommendation #1. The voting members of the marketable condition work group recommend that the Department of the Interior resolve an ambiguity in its current regulations by publishing a proposed rule to amend the regulation at 30 C.F.R. 1202.151(b) to remove language specific to the boosting of residue gas:

> **Revise 30 C.F.R. 1202.151(b) to read as follows:**
>
> A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant. In those situations where a processing plant processes gas from more than one lease, only that proportionate share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free.

3. Unbundling vs Standardized Table for Calculating Allowances and Disallowances

The marketable condition work group continues its efforts to resolve the other compression issues identified above. It is also evaluating whether ONRR-generated plant-specific and region-specific unbundling cost allocations (UCAs), together with any index-based valuation formula the RPC may recommend, will resolve the remaining marketable condition issues. Because they may not, and also for possible use as a component of any index-based valuation formula, the marketable condition work group is evaluating whether to develop and recommend a standardized table a lessee may or must use to calculate the non-allowable portion of a transportation or processing fee to cover its costs to compress, dehydrate, and sweeten gas to marketable condition.

ONRR continues to make progress in generating UCAs for gas plants and transportation systems. ONRR has unbundled and published UCAs for approximately twenty-five gas plants—some with included transportation systems. ONRR plans to continue its efforts and provide additional UCAs that are not limited to specific plants, but cover either geographic regions or categories of plants ("standardized UCAs"). ONRR's experience with unbundling is allowing it to streamline the process.

For those plants where there is not an ONRR-generated UCA, and even where there is an ONRR-generated UCA, but a lessee concludes that an ONRR-generated UCA disallows too much of its transportation or processing costs, the lessee may or must unbundle itself, though with difficultly, particularly where it transports or processes its gas under an arms-length transportation or processing contract. In these instances, a lessee often finds unbundling:

- Very difficult to perform due to lack of information except on an estimated basis which creates disagreements.

- Very burdensome and costly to calculate an estimate, and burdensome to audit; many companies are enlisting consultants.

- Legal differences exist between ONRR's unbundling method resulting in ONRR disallowing transportation or processing costs even when the lessee has otherwise already put the gas in marketable condition at its own expense.

- ONRR often generates a single UCA for a specific plant (and possibly the connected transportation system), which is a one-size-fits-all approach, but gas that enters the plant or system may differ as to the amount of compression, dehydration, and sweetening it requires, and may have to travel more miles through more expensive pipe than some other gas entering the same plant or system.

- ONRR's standardized UCAs have the same accuracy and legal issues as ONRR's plant-specific unbundling – this is a nice attempt, but it may not be the answer due to the inherent problems and limitations of calculations.

Standardized Table for Calculating Allowances /Disallowances

A standardized table brings certainty and administrative simplicity and would provide an option for using a table rather than unbundling when ONRR-generated UCAs are not available. ONRR would calculate and post these rates for costs to be carved out of otherwise-allowable transportation and processing fees so as to cover the cost to compress, dehydrate, and sweeten gas to marketable condition. The rates would be based upon the difference between the lessee's gas at the royalty measure point and marketable condition requirements, and possibly differences in pipeline and plant technologies and volumetric throughput, as well as other factors. Producers would consult this table to determine the total compression, dehydration, and sweetening costs deemed necessary to place gas into a marketable condition and hence not deductible as a part of a transportation or processing allowance.

Path Forward: The marketable condition work group will further discuss and evaluate a standardized table to calculate allowances and disallowances, building on the many hours the work group has spent to date. Evaluation may include an economic analysis to support a future recommendation.

Fair Return and Value Committee
Coal Valuation Work Group
February 27-28, 2018

1. Background on Coal Valuation Benchmarks

The coal valuation benchmarks are promulgated under the Mineral Leasing Act of 1920. As such, a background discussion of both law and regulation is beneficial to understand the framework.

Mineral Leasing Act of 1920

When Federal royalty is based on the value of the mineral, it has always been based on the value of the mineral "at the mine." When the Mineral Leasing Act of 1920 (MLA), 30 U.S.C. §§ 181-287, was first enacted, the royalty on most minerals (but not coal) was set as a percentage of the value of the mineral. *See, e.g.,* 41 Stat. 437, 443 (1920) (royalty for oil and gas "shall not be less than 12 1/2 per centum in amount or value of the production"). For the value-based royalties, the legislative history is replete with evidence that Congress and the Department of Interior intended the value to be determined "at the mine." For example, for Federal phosphates and phosphate rock reserves, the legislative history provides that value is based "at the mine." *See, e.g.*, 53 CONG. REC. 1098 (1916) (royalties shall be based on "the gross value of the output of phosphates or phosphate rock at the mine"); H.R. REP. No. 17, 11 (1916) (Secretary Lane's report provides that phosphate royalty should be based on "the gross value of the output at the mine"); 58 CONG. REC. 4055 (1919) ("the gross value of the output of phosphates or phosphate rock at the mine"). The MLA legislative history is the same for potassium and sodium. *See, e.g.*, H.R. REP. No. 17, 8 (1916) (potassium or sodium royalty is based on "the value of the output at the point of production").

In 1920, royalty on coal under the MLA was based on a cents per ton calculation that had little to do with the value of the coal. 41 Stat. 437, 439 (1920) (royalty for coal "shall not be less than 5 cents per ton of two thousand pounds"). It was not until the Federal Coal Leasing Act Amendments of 1976 (FCLAA), Pub. L. 94-377, 90 Stat. 1083, that Congress changed the royalty basis for coal to a percentage of its value. H.R. REP. No. 94-681, 81 (1975) ("the revised language changes the minimum royalty from $.05 per ton to twelve and one half per centum of the value of the coal, except that the Secretary may determine a lesser amount for underground mining operations").

When Congress adopted a value-based royalty for coal, it reiterated its intent that when royalty is based on the value of the mineral, the value is determined "at the mine." The legislative history for the FCLAA amendments regarding advance royalty payments provides that standard royalty rates are based on "the gross value of the coal at the mine." *See* Senate Rep. No. 94-296, 49 (1976). One year after the FCLAA was enacted, Congress passed the Abandoned Mine Reclamation Fund, Pub. L. 95–87, 91 Stat. 445 (1977), which is administered by the Secretary of the Interior and imposes a reclamation fee on all coal mines. The fee is assessed as a percentage of "the value of the coal at the mine." 30 U.S.C. § 1232.

Consistent with legislative and Departmental intent, courts since the 1940s have held that the government's royalty interest is limited to the value of production at the mine. *United States v. Gen. Petroleum Corp. of Cal*., 73 F. Supp. 225, 258 (S.D. Cal. 1946) (gas royalty obligation is determined "at the leases, that is before it left the field"), *aff'd sub. nom. Cont'l Oil Co. v. United States*, 184 F.2d 802, 820 (9th Cir. 1950) ("royalties were to be calculated at values at the wells, not at the . . . destination"); *Indep. Petroleum Ass'n of Am. v. Armstrong*, 91 F. Supp. 2d 117, 119 (D.D.C. 2000) ("the essential bargain embodied in federal and Indian leases entitled the lessor to a royalty based upon the value of production at the lease"), *aff'd in part, rev'd in part on other grounds Indep. Petroleum Ass'n of Am. v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002).[1]

Further, courts have consistently invalidated any Department of Interior regulation or policy that is contrary to the MLA's intent. *See, e.g., Plateau, Inc. v. Dep't of Interior*, 603 F.2d 161, 164 (10th Cir. 1979) (invalidating regulation governing Federal royalty oil because, based on legislative history, the court found the regulation "goes beyond what Congress authorized"); *Marathon Oil Co. v. Andrus*, 452 F.Supp. 548, 552-53 (D. Wyo. 1978) (invalidating agency oil and gas royalty policy as conflicting with "the legislative history of the Mineral Leasing Act, together with its many enactments and re-enactments"); *Indep. Petroleum Ass'n*, 91 F. Supp. 2d at 125 (invalidating MMS regulation which disallowed transportation deduction for unused pipeline firm transportation charges, which MMS claimed were not "actual" costs incurred to move gas downstream, because the disallowance led to a definition of "value" inconsistent with the MLA's intent that royalty should be based at the lease), *rev'd on other grounds,* 279 F.3d at 1042-43.

Coal Valuation Regulations

The current Federal and Indian coal regulations have been in effect since 1989. *See Revision of Coal Product Valuation Regulations and Related Topics,* 54 Fed. Reg. 1492 (January 13, 1989). Under the existing regulations, if the lessee sells coal under a non-arm's-length arrangement, the regulations prescribe an ordered series of "benchmarks" that look to outside indicia of market value. The value of the coal is based on the first applicable benchmark, as follows:

1. Under the first of those benchmarks, the gross proceeds accruing to the lessee under its non-arm's-length contract will be accepted as value, if they are within the range of the gross proceeds derived from or paid under comparable arm's-length contracts (from other producers, i.e. not comparable sales by the lessee) for the sale or purchase of like-quality coal produced in the area. 30 C.F.R. §§ 1206.257(c)(2)(i) (Federal coal) and 1206.456(c)(2)(i) (Indian coal).
2. The second benchmark establishes value based on "[p]rices reported for that coal to a public utility commission." *Id.* §§ 1206.257(c)(2)(ii) and 1206.456(c)(2)(ii).
3. Under the third benchmark, value is established based on "[p]rices reported for that coal to the Energy Information Administration of the Department of Energy." *Id.* §§ 1206.257(c)(2)(iii) and 1206.456(c)(2)(iii).
4. If the third benchmark does not apply, then value is based on "other relevant matters," which include, but are 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 of certain types of coal." *Id.* §§ 1206.257(c)(2)(iv) and 1206.456(c)(2)(iv).
5. Lastly, if none of the four preceding benchmarks apply, then "a net-back method or any other reasonable method shall be used to determine value." *Id.* §§ 1206.257(c)(2)(v) and 1206.456(c)(2)(v).

Of note, if application of the benchmarks result in a value less than the gross proceeds from the non-arm's length transaction between lessee and its affiliate, then the non-arm's length transaction will govern value for royalty purposes. 30 C.F.R. 1206.257(g).

These benchmarks have been applied since 1989 with little indication that the benchmarks are not workable. At most, there has been occasional disagreement between lessees and ONRR over whether sales are considered arm's-length or non-arm's-length or over which is the first applicable benchmark. For example, in *Decker Coal Co.*

[1] Although these cases involve royalty on oil and gas, the stated principles are equally applicable to coal royalty valuation. *See Black Butte Coal Co. v. United States*, 38 F. Supp. 2d 963, 971 (D. Wyo. 1999) ("Simply because [prior cases] involve gas and oil as opposed to coal is not a compelling reason to ignore them. The decisions' discussion of the assessment of royalties is functionally indistinguishable . . .").

v. United States, No. CV-07-126-BLG-RFC, 2009 WL 700221 (D. Mont. Mar. 17, 2009), the issue was not that the benchmarks were unworkable or led to unreliable valuations; the issue was that ONRR's predecessor, the Minerals Management Service (MMS), erred by proceeding to the fourth benchmark when the first benchmark was applicable, contrary to the regulation's mandate. *Id.* at *2, *9. However, coal lessees not being allowed to use their own arm's-length sales to value non-arm's-length sales of coal from the same mine, which has led to a lack of clarity and significantly enhanced costs and administration due to avoidable audit issues, appeals and litigation.

Coal Valuation Rulemaking History

When the valuation benchmarks were first proposed in 1987, the first benchmark would allow for consideration of the lessee's own comparable sales. The 1987 preamble (52 Fed. Reg. at 1843 (Jan 15, 1987)) provides:

- "Hence, for the first benchmark, pursuant to proposed § 206.259(c)(2)(i), if the gross proceeds under a non-arm's-length contract are equivalent to the lessee's gross proceeds derived from, or paid under, comparable arm's-length contracts for the sale or purchase of like-quality coal in the area, then the gross proceeds would be acceptable as value."

Again in 1988, when the benchmarks were proposed for the second time, the first benchmark would allow consideration of the mine's own comparable sales. MMS explained:

- "The-first benchmark is still based upon the lessee's gross proceeds from the disposition of the coal. However, the proposed rule has been modified so that, before the lessee's gross proceeds would be acceptable as value, they must be equivalent not just to the gross proceeds under the lessee's other arm's-length contracts, but they must be equivalent to the gross proceeds under arm's-length contracts involving other buyers and sellers in the area." 53 Fed. Reg. at 26951 (July 15, 1988).

The proposed language of the first benchmark provided:

- "(i) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition by other than an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under...comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality coal in the area." 53 Fed. Reg. at 26960.

In 1989, when the valuation benchmarks were finalized, MMS eliminated the ability to consider the mine's own comparable sales; however, the preamble does not describe the reason for the change. MMS noted that some comments were raised by Tribes on the issue:

- "Two Indian commenters recommended ignoring arm's-length contracts of the lessee and seeking "[t]he highest gross proceeds" in "the same coal field" or alternatively "from other coal fields" as being the first two preferred valuation criteria." 54 Fed. Reg. at 1514.

But ultimately the rule's preamble does not acknowledge the change and actually contains some language that is inconsistent with the change:

- "Therefore, the first criteria to be applied are market-based value determinants. The lessee would be required to compare its non-arm's-length contract with its comparable arm's-length contracts and to other comparable arm's-length contracts of coal producers in the same area." *Id.* at 1515.

Further, MMS's decision to exclude the lessee's own comparable arm's-length sales from the first coal benchmark was inconsistent with the valuation benchmarks that were adopted for non-arm's-length sales of natural gas, which have always allowed an oil and gas lessee to determine value based on its own comparable arm's-length sales. *See* 30 C.F.R. § 1206.152(c)(1).

Value at the Mine is Best Determined By Examining Comparable Arm's-Length Sales

The current benchmarks reflect the long-held and universal view that the best method for determining value at the mine is examining comparable arm's-length sales. *See* 54 Fed. Reg. 1,492, 1,500 (Jan. 13, 1989) ("The arm's-length valuation standard is the most commonly utilized and the most accurate representation of any good's true worth . . ."); *see also* 76 Fed. Reg. 30881, 30882 (May 27, 2011) ("The Department of the Interior has long held the view that the sales prices agreed to in arm's-length transactions are the best indication of market value. The 1989 regulations reflect that view.").

As mentioned above, when the benchmarks were adopted, MMS included a comparison to arm's-length sales in the same area as the producer's mine in the first benchmark. 54 Fed. Reg. at 1506. Accordingly, it was MMS's intent that arm's length sales in the area should be viewed as the most reliable indicator of value for purposes of valuing non-arm's length sales from the same location.

Consistent with reliance on a comparable sales approach, MMS's 1996 guidance on affiliate sales of coal provides that affiliate resales of coal may be used to determine value, but only where the resale occurs in the same area as the mine. *See* "General Guidance for Auditing Affiliate Sales of Coal" at 1 (November 26, 1996) ("If a resale of production from the affiliate to a third party occurs *in the same field or area* as the sale from the lessee to its affiliate, the proceeds under the arm's-length resale contract may be used in calculating the applicable benchmark value." (emphasis added)).

In royalty cases on private lands involving affiliate sales, courts have applied the comparable arm's–length sales approach to determine market value at the lease as "[t]he first, and most desirable" approach. *Potts v. Chesapeake Exploration, L.L.C.*, No. 3:12-CV-1596-O, 2013 WL 874711, at *5 (N.D. Tex. Mar. 11, 2013), *aff'd*, 760 F.3d 470, 474 (5th Cir. 2014) ("The most desirable method is to use comparable sales"). In other valuation cases, not involving affiliate sales, courts similarly prefer the comparable sales valuation approach to determine a value at the lease. *E.g., Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381, 387 (10th Cir. 1975) ("It is obvious that the comparable sales-current market price is by far the preferable method when it can be used."); *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶ 14, 768 N.W.2d 496, 501 ("Most courts prefer the comparable sales method."); *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 463 F. Supp. 619, 620 (N.D. Okla. 1978) ("Optimally, a product's 'fair market value' is determinable by examining comparable sales of the same product."), *aff'd in part, rev'd in part,* 607 F.2d 335 (10th Cir. 1979); *Anderson Living Trust v. ConocoPhillips Co., LLC*, 952 F. Supp. 2d 979, 1040 n.9 (D. N.M. 2013) ("evidence of comparable wellhead sales is the best possible evidence for analyzing market value at the well.").

2. Issue: Coal Companies Cannot Value Non-Arm's Length Sales Using the Most Reliable Method

Although the first benchmark under the current regulations allows a lessee to value its coal sold under a non-arm's-length contract based on the value of comparable arm's-length contracts in the area, the first benchmark limits the lessee's comparability analysis to "comparable arm's-length contracts (<u>from other producers, i.e. not comparable sales by the lessee</u>)." 30 C.F.R. §§ 1206.257(c)(2)(i) (Federal coal) (emphasis added) and 1206.456(c)(2)(i) (Indian coal).

This limitation is problematic for two main reasons. First, by excluding the lessee's own comparable arm's-length contracts, it prevents consideration of the most reliable data for determining value – the mine's own comparable arm's-length sales at the mine for the same quality coal. Second, by limiting the comparability analysis to other producer's contracts, the first benchmark becomes virtually impossible for the lessee to apply. Lessees typically do not have access to their competitors' sales contracts; therefore, at the time a lessee makes its royalty payments, the lessee is unable to determine whether its gross proceeds are comparable to its competitors' sales contracts.

As a result, the first benchmark currently prevents coal lessees from using the most reliable valuation method – a comparable sales approach – to value its non-arm's-length sales.

3. Recommendations

The recommendations with regard to coal valuation by the voting members of the Fair Return and Value Subcommittee are as follows:

1. The Department of the Interior reinforce its consistent principle that arm's length transactions are the best indication of market value by amending the regulation at 30 C.F.R. 1206.257(c)(2)(i) to read:

    a. "The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition by other than an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality coal in the area."

2. The Department of the Interior issue a Secretarial Order, Dear Payor Letter and/or a Policy Memorandum indicating that a lessee's own arm's length sales are preferential under 30 C.F.R. 1206(c)(2)(iv) at least until the rulemaking process has run.

3. The Department of the Interior update the Solids Minerals Reporting Handbook in accordance with items 1 and 2 above.

These changes would ensure that valuation methodology of non-arm's length coal sales is consistent with the "at the mine" legislative intent and would conform the coal valuation methodology to substantially similar terms as gas and oil. Further, this change would ensure that the most consistent and reliable non-arm's length valuation methodology would be utilized. The resulting clarity and consistency would significantly increase efficiencies within the coal royalty payment process – reducing the time of audits, eliminating a number of unnecessary appeal issues and significantly lower the likelihood of costly and inefficient litigation.

Payor Handbook Update

Royalty Policy Committee
Fair Return and Valuation Sub-Committee
Payor Handbook Working Group
February 2018

Payor Handbook Working Group

- ONRR participants:
  - Amy Lunt
  - Megan Hessee
  - Jodie Peterson
  - Helen Virene
  - Gina Liles
  - Kimberly Jackson
  - Cindy Gothberg
- Tribal participants:
  - Adam Red
  - Rowena Cheromiah
  - Brian Bex
- State participant:
  - Representative Drew Darby
- Academia/Public Interest participant:
  - Van Romero
- Industry participants:
  - Greg Morby
  - Matthew Adams
  - Stella Alvarado
  - Gabrielle Gerholt
- Technical Resource participant:
  - Judy Matlock

Background

- Last updated in 2000
- General support from ONRR and Industry for update
- ONRR had started update prior to formation of RPC

Current Status

- Corrections and updates needed
  - Wet versus dry
  - Valuation basics
- Create two handbooks
  - Indian
  - Federal

Recommendation

- Create “evergreen” handbook which can be updated regularly and link to recent rules and decisions

RECOMMENDATION SUMMARY

Royalty Policy Committee
Fair Return and Valuation Sub-Committee
Index Pricing Working Group
February, 2018

Index Price Working Group

ONRR participants:

- *Chris Carey*
- *Robert Sudar*
- *Nicholas Van Gundy*
- *Karl Wunderlich*

Tribal participants :

- *Adam Red (Southern Ute Indian Tribe)*
- *Lorelyn Hall (Southern Ute Indian Tribe)*

Academia/Public Interest participants:

- *Rod Eggert (Colorado School of Mines)*
- *Van Romero (NM Institute of Mining)*

Industry participants :

- *Matthew Adams (Cloud Peak Energy)*
- *Estella Alvarado (Anadarko)*
- *Gabrielle Gerholt (Concho)*
- *Greg Morby (Chevron)*
- *Pat Noah (ConocoPhillips)*

Technical Resource participant:

- *Mike Foster (ConocoPhillips)*

Background

- General support among Payors for Index Pricing concept
- Potential to resolve many Marketable Condition issues
- Index Price provision contained within repealed 2017 Federal Valuation Rule was not received well by Payors
  - *the highest reported price was unachievable and reflected index points not representative of how the gas was actually marketed;*
  - *transportation cost deductions were unreasonably low; and*
  - *the resulting price could only be used for non-arms-length sales types*

Work Flow

- Reviewed and discussion of comments collected from 2017 COPAS/ONRR valuation meeting
- Review and discussion of a valuation rules matrix
- Review and discussion of Indian Index Price approach
- Review and discussion of potential considerations in potential Index Price rulemaking
- Draft, review and discussion of draft proposal
- Discussion of potential approach (negotiated rulemaking versus rulemaking)

Recommendation

Pursue rulemaking to define simplified index price rules for Federal gas.

Key factors to be addressed by this rule:

- A standardized average single price (per defined geographic area) acceptable to both payors and DOI/ONRR
- Calculated (by ONRR) from generally accepted index price publications or other market-sensitive source
- Apply price to wellhead (or royalty measurement point MMBTUs
- Incorporate reasonable geographically sensitive transportation deductions
- Apply price to all Federal gas sales types

Recommendation

Additional factors for consideration in the rulemaking process:

- Should utilization of the price be mandatory or optional by payors?
- Should the “bump” approach of Indian Alternate dual accounting be utilized?

Royalty Policy Committee
Fair Return and Valuation Sub-Committee

Work Group

Marketable Condition

February 28, 2018

Marketable Condition

Discussion

Background & Boosting

A lessee is required to put gas into marketable condition once at its own expense.

Boosting has commonly been accepted throughout Industry as meaning the compression of natural gas in a Gas Processing Plant from its pressure (expressed in pounds per square inch or PSI) after the extraction of Natural Gas Liquids (NGLs) to PSI levels sufficient to allow the Residue Gas (gas remaining after the extraction of NGLS) to flow into natural gas pipeline(s) that will transport it to downstream markets.

ONRR and industry currently disagree on the interpretation of the current boosting regulation. Current ONRR interpretation requires that Industry condition gas to mainline pipeline specifications **twice**, once in an unprocessed condition as it is produced from the ground and a second time after the gas is processed at a downstream Natural Gas Processing plant. A recommendation to change the boosting language will resolve the difference of interpretation between industry and the Department.

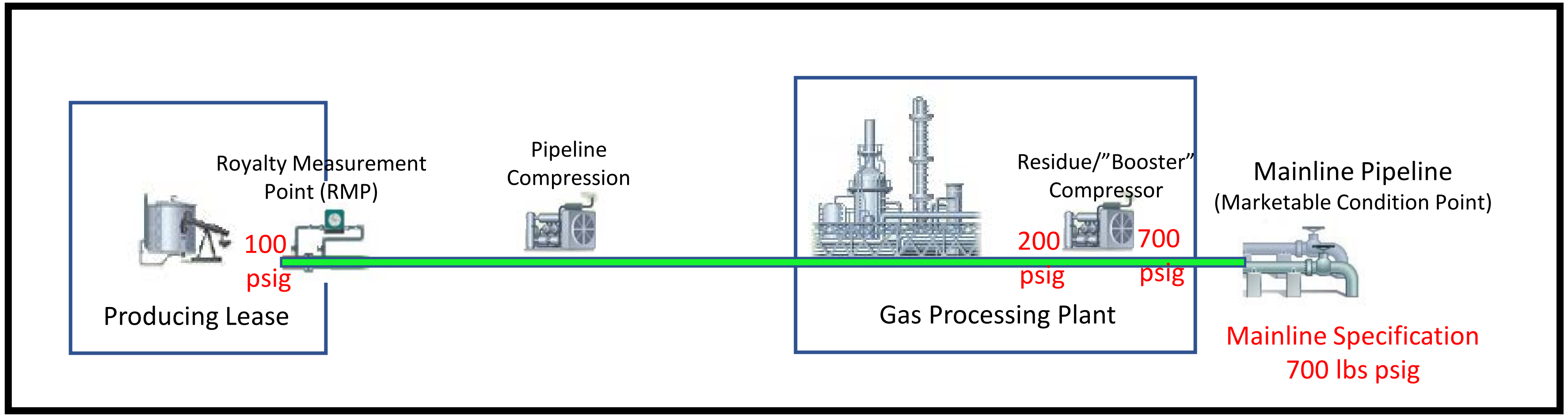
Marketable Condition

Boosting Regulations – Compression Required for Marketable Condition or otherwise

Three disputes. For at least three reasons, ONRR and industry currently disagree on the compression a lessee must provide at its own expense to put gas into marketable condition:

- Is boosting residue gas part of the marketable condition requirement or a separate requirement?
- Achieve Marketable condition or sum to marketable condition?
- Compression needed to put NGLs' into marketable condition?

Marketable Condition Example



Placing Gas in Marketable Condition Once

Compressor	Calculation	Total Disallowed Pressure
Booster Compression	(Booster Discharge – Booster Inlet) (700 – 200)	500 lbs psig
Compression	(Booster Inlet –Pipeline Compression)(200 - 100)	100 lbs psig
Total Disallowed	(Mainline Receipt – Pipeline Compression) (700 – 100)	600 lbs psig

- Allows lessee to use booster to reach mainline pressure
- Pressure needed to reach mainline specs is disallowed
- Lessees will not deduct cost of booster nor 100 lbs of pipeline compression. Hence, we are not charging ONRR for boosting.

Placing Gas in Marketable Condition Twice

Compressor	Calculation	Total Disallowed Pressure
Booster Compression	(Discharge – Inlet) (700 – 200)	500 lbs psig
Compression	(Mainline Receipt – Pipeline Compression) (700 - 100)	600 lbs psig
Total Disallowed	(Mainline Receipt – Pipeline)+ (Booster)	1100 lbs psig

- Requires lessee to reach marketable condition pressure prior to the plant AND after processing (i.e. twice)
- Lessee are not allowed to use booster to reach mainline pressure
- Requires lessee to provide more pressure 'free-of-cost' than is necessary to reach mainline pipeline (marketable condition) specifications

Marketable Condition

ONRR's regulation on boosting residue gas applies only to federal gas. It currently reads:

> (b) A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, <u>but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 CFR part 206.</u> In those situations where a processing plant processes gas from more than one lease, only that proportionate share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free.

Marketable Condition

Recommendation

The voting members of the marketable condition work group recommend that the Department of the Interior resolve an ambiguity in its current regulations by publishing a proposed rule to amend the regulation at 30 C.F.R. 1202.151(b) to remove language specific to the boosting of residue gas:

Revise 30 C.F.R. 1202.151(b) to read as follows:
A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant. In those situations where a processing plant processes gas from more than one lease, only that proportionate share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free.

Marketable Condition

Discussion

Unbundling

ONRR continues to make progress in generating unbundling cost allocations (UCAs) for gas plants and transportation systems. ONRR has unbundled and published UCAs for approximately twenty-five gas plants—some with included transportation systems.

For those plants where there is not an ONRR-generated UCA, and even where there is an ONRR-generated UCA, but a lessee concludes that an ONRR-generated UCA disallows too much of its transportation or processing costs, the lessee may or must unbundle itself, though with difficultly, particularly where it transports or processes its gas under an arms-length transportation or processing contract.

Marketable Condition

Standardized Table for Calculating Allowances/Disallowances

A standardized table brings certainty and administrative simplicity and would provide an option for using a table detailing cost for the various marketable condition services (i.e. compression, treating, dehydrating) rather than requiring individual companies to determine their own costs for these services.

Path Forward

The marketable condition work group recommends that it further discuss and evaluate a standardized table to calculate allowances and disallowances, building on the many hours the work group has spent to date. Evaluation may include an economic analysis to support a future recommendation.

Marketable Condition

ONRR participants:

- Bonnie Robson
- Karl Wunderlich
- Sara Corman

Tribal participants :

- Adam Red (Southern Ute Indian Tribe)

Industry participants :

- Matthew Adams (Cloud Peak)
- Stella Alvarado (Anadarko)
- Greg Morby (Chevron)
- Pat Noah (ConocoPhillips)

Academia:

- Roderick Eggert, CO School of Mines

Technical Resource participant:

- Mike Foster (ConocoPhillips)

Royalty Policy Committee
Fair Return & Value Subcommittee

Coal Valuation Working Group

February 27-28, 2018

ISSUE

- Unlike the gas and oil valuation rules for non-arm’s length sales, the coal valuation benchmarks do not expressly state that a lessor’s arm’s length sales are the preferred valuation methodology for non-arm’s length sales. Without a clear ‘best’ valuation methodology, different methodologies are being used by lessors and ONRR without guidance on what is ‘most reasonable’.
  - The consequence has been an increase in appeals, uncertain reporting methodologies, lack of consistency in valuation determinations and an upcoming dramatic increase in time and expense associated with litigation. Additionally, the current environment is making federal coal less competitive than state or private coal when non-arm’s length sales are contemplated.

Why Lessees use Logistics Companies

- Logistics companies are typically used to provide services to customers when the delivery point is remote from the lease in order to mitigate various risks and costs from impacting the lessee. Logistics companies incur substantial cost and risks associated with transporting coal significant distances to coal ports, including:
    - Inherent increased risk of dealing with overseas customers,
    - Retaining legal title to the coal and risk of loss until it is loaded on the customer’s vessel at the terminal,
    - Incurring terminal and rail fees,
    - Risking rail interruptions,
    - Paying demurrage charges,
    - Rail and port requirements force logistic companies to commit to long-term contracts, which include take-or-pay provisions.

Non-Arm's Length Coal Valuation Benchmarks - Summary

1. The gross proceeds accruing to the lessee under its non-arm's-length contract will be accepted as value, if they are within the range of the gross proceeds derived from or paid under comparable arm's-length contracts (from other producers, i.e. not comparable sales by the lessee) for the sale or purchase of like-quality coal produced in the area. 30 C.F.R. §§ 1206.257(c)(2)(i) (Federal coal) and 1206.456(c)(2)(i) (Indian coal).
2. The second benchmark establishes value based on "[p]rices reported for that coal to a public utility commission." *Id.* §§ 1206.257(c)(2)(ii) and 1206.456(c)(2)(ii).
3. Under the third benchmark, value is established based on "[p]rices reported for that coal to the Energy Information Administration of the Department of Energy." *Id.* §§ 1206.257(c)(2)(iii) and 1206.456(c)(2)(iii).
4. If the third benchmark does not apply, then value is based on "other relevant matters," which include, but are 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 of certain types of coal." *Id.* §§ 1206.257(c)(2)(iv) and 1206.456(c)(2)(iv).
5. Lastly, if none of the four preceding benchmarks apply, then "a net-back method or any other reasonable method shall be used to determine value." *Id.* §§ 1206.257(c)(2)(v) and 1206.456(c)(2)(v).

Of note, if application of the benchmarks result in a value less than the gross proceeds from the non-arm's length transaction between lessee and its affiliate, then the non-arm's length transaction will govern value for royalty purposes. 30 C.F.R. 1206.257(g).

1987/1988 / 1989 Valuation Rulemaking

- When the valuation benchmarks were first proposed in 1987, the first benchmark provided for consideration of the lessee's own comparable sales. The 1987 preamble (52 Fed. Reg. at 1843 (Jan 15, 1987) provides:
- · "Hence, for the first benchmark, pursuant to proposed § 206.259(c)(2)(i), if the gross proceeds under a non-arm's-length contract are equivalent to the lessee's gross proceeds derived from, or paid under, comparable arm's-length contracts for the sale or purchase of like-quality coal in the area, then the gross proceeds would be acceptable as value."

- <u>1988 Coal Valuation Rulemaking</u>: Again in 1988, when the benchmarks were proposed for the second time, the first benchmark would allow consideration of the mine's own comparable sales. MMS explained:
- · "The-first benchmark is still based upon the lessee's gross proceeds from the disposition of the coal. However, the proposed rule has been modifed so that, before the lessee's gross proceeds would be acceptable as value, they must be equivalent not just to the gross proceeds under the lessee's other arm's-length contracts, but they must be equivalent to the gross proceeds under arm's-length contracts involving other buyers and sellers in the area." 53 Fed. Reg. at 26951 (July 15, 1988).
- The proposed language of the first benchmark provided:
- · "(i) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition by other than an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under...comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality coal in the area." 53 Fed. Reg. at 26960.

- <u>1989 Coal Valuation Final Rule</u>: In 1989, when the valuation benchmarks were finalized, MMS eliminated the ability to consider the mine's own comparable sales; however, the preamble does not describe the reason for the change. MMS noted that some comments were raised by Tribes on the issue:
- · "Two Indian commenters recommended ignoring arm's-length contracts of the lessee and seeking "[t]he highest gross proceeds" in "the same coal field" or alternatively "from other coal fields" as being the first two preferred valuation criteria." 54 Fed. Reg. at 1514.
- But ultimately the rule's preamble does not acknowledge the change and actually contains some language that is inconsistent with the change:
- · "Therefore, the first criteria to be applied are market-based value determinants. The lessee would be required to compare its non-arm's-length contract with its comparable arm's-length contracts and to other comparable arm's-length contracts of coal producers in the same area." *Id.* at 1515.

Recommendations

1. The Department of the Interior reinforce its consistent principle that arm’s length transactions are the best indication of market value by amending the regulation at 30 C.F.R. 1206.257(c)(2)(ii) to read:
   - “(i) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition by other than an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality coal in the area.”
2. The Department of the Interior issue a Secretarial Order, Dear Payor Letter and/or a Policy Memorandum indicating that a lessee’s own arm’s length sales are preferential under benchmark 4 while the rulemaking process has run.
3. The Department of the Interior update the Solids Minerals Reporting Handbook in accordance with items 1 and 2 above.

Royalty Policy Committee

Fair Return & Value Subcommittee

Audit Work Group Report– February 7, 2018

Audit Work Group

Overview

The Audit Work Group ("AWG") industry members initially met to discuss audit related problems, concerns, and areas for improvement broadly categorized as follows:

- Audit coordination and timing
- Audit conduct and resource allocation
- Audit closure

Subsequent meetings provided ONRR staff the opportunity to outline improvements expected from the recently developed Operations Management Tool (OMT) being implemented during Fiscal Year 2018. Further OMT highlights are noted on the next slide. ONRR staff further communicated:

- The cost of performing audits, and a related Return on Investment, has been tracked since the mid 1990s.
- Improvements are an ongoing concern, and effort, with recommendations periodically being received from GAO, OIG, and past and present RPCs.
- During the last Fiscal Year, 153 audits and more than 600 compliance reviews were completed. Approximately 2/3rds of disagreements resolved before completion of Preliminary Determination.

Audit Work Group

Scope of Work

AWG identified problem

- Overlap of audits -different ONRR and State delegated teams auditing or reviewing the same periods and properties at the same, or different, times.
- Allocating sufficient and experienced resources for the efficient conduct of the audit.
- Audits do not begin soon enough or conclude in a timely manner.

Status – the ONRR Operations Management Tool should address the above problems through improvements such as:

- Better audit management through improved categorization of audits beyond New / Open / Closed.
- Assigning milestone activities and due dates necessary to keep efforts progressing at a pre-established pace
- A reduction in audit cycle time from 2-3 years to 16 months.
- Payor provided source documentation will be stored electronically and available to associated agencies.
- Consistent data request based on one template

Audit Work Group

Scope of Work - continued

AWG identified problem **-** Inconsistent interpretation and application of valuation regulations among ONRR, States, Tribes, and companies.

Status **-** The ONRR Asset Valuation Group is developing an electronic database capturing and cross-referencing guidance by keyword / issue with read only access available to other groups such as compliance and audit.

AWG identified problem **-** Unresolved issues and guidance can lead to a logjam open audit periods.

Status **-** Filling vacant appeals analyst positions should aid with the appeals backlog.

Recommendation –As a result of the ONRR efforts referenced above, the AWG concluded no recommendation for RPC consideration is required at this time. The AWG will monitor the expected improvement.

Additionally, the AWG sees the potential for lessening audit burden, time, and expense, in the recommendations developed by the other Fair Return and Valuation Subcommittee Work Groups (Coal, Index Pricing, Marketable Condition and the Payor Handbook).

Audit Work Group

Members

• John Barder	ONRR
• Adam Red	Tribes
• Kwame Awuah-Offei	NGO
• Greg Morby	Industry
• Pat Noah	Industry
• Stella Alvarado	Industry
• Matthew Adams	Industry

ONRR COMPLIANCE PROCESS IMPROVEMENT

February 28, 2018

Audit Management

Paul Tyler
Program Director

Coordination & Support/ OMT Sponsor
Roman Geissel
Program Manager

Indian & State Audit
Patrick Milano
Program Manager

Southern Federal Audit
Shawna Schimke
Program Manager

Western Federal Audit
Judith Clark
Program Manager

Process Improvement Initiative

- Improve Compliance Business Processes
- Align Sufficient & Skilled Resources
- Provide the Foundation for Development of the Operations Management Tool (OMT)

Process Improvement Focus

- Increase Productivity/Compliance Coverage
  - Eliminate unnecessary steps & duplication
  - Reduce cycle times
- Maximize Results
  - Focus resources on areas of potential misreporting
- Enhance Quality of Audits
  - Ensure a favorable peer review opinion

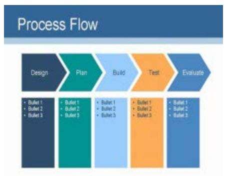
Process Improvement Focus

- Implement Status Tracking and Transparency
- Track Cases from Beginning to Closure
  - Including appeals and other enforcement activities
- Leverage Technology (OMT)
  - Work planning coordination
  - Workflow structure
  - Electronic workpapers
  - Automated notifications
  - Information sharing

OMT is an Integrated ONRR-Wide Tool

Automates planning, execution, monitoring, measurement, and reporting on all compliance processes

Increase Management visibility and insight into processes.



Simplify processes while increasing quality.

Reduce time to perform compliance activities.

ONRR-Wide Benefits:

Work Management

- ONRR-wide (and STRAC) automation
- Automated work management & risk analysis
- Business process metrics to drive process improvement
- Optimized for multiple users
- Enhanced automation to speed process closure
- Mitigation of overlapped work

Standardized Process

- Consistent Work Products
- Process standardization and sustainability
- Standardized Milestones
- Electronic document & case file storage in one central tool
- Electronic "workpapers"

Transparency

- Data security
- Electronic file backups
- Fast accumulation of data for metrics tracking
- Ease of high level activity transparency
- Shared view of case & status

Process Improvements

- Introduces Phases, Milestones and Tasks to Track Audit Status and Progress

- Establishes a Standard Audit Process and Eliminates Unnecessary Steps
  - Uniform workflow and custom audit procedures for each audit
  - Consistent file index and workpaper structure

- Utilizes ONRR-Wide Work Products
  - Consistent communication to industry; system generated work products

Process Improvements

- Addresses Audit Process Consistency
  - Structures supervisory/management review process
  - Defines escalation process when companies do not respond
  - Outlines systemic issues
  - Establishes sampling standards
  - Uses thresholds to manage work
  - Distinguishes closure letters verses audit reports

Process Improvements

- Reduces Audit Cycle Times
  - Provides structure and clear guidance leading to a more efficient process
  - Decreases review and processing time by using system generated work products
  - Minimizes time lost when transferring cases between employees
  - Allows audit closure where no findings exist (RSFA)
  - Ensures GAGAS standards are met reducing the risk of peer review findings
  - Improves management oversight

OMT Schedule

Compliance Reviews (ONRR)	January 2017
Audit (ONRR - Process only)	March 2017
Compliance Reviews (STRAC)	Pilot Dec 2017
Data Mining	January 2018
Audits (ONRR - OMT)	June 2018
Appeals (Assessment)	FY 2019
Enforcement (Assessment)	FY 2019
Valuation (Assessment)	FY 2019
Audits (STRAC)	FY 2019

Audit Work Group Issues

Issue	Response
Overlap of audits, meaning different ONRR and State delegated teams auditing/ reviewing the same periods and properties at the same or different times.	**Process Improvements** ➢ Realign ONRR, States and Tribes organizationally ➢ Focus assignments on attributes **OMT** ➢ Centralizes Work Management – Provides view of all compliance work (AM, STRAC, Compliance Management) – Identifies and flags overlap properties and companies – Shows current production/royalty information – Identifies compliance targets

Audit Work Group Issues

Issue	Response
Allocating sufficient and experienced resources for efficient conduct of audit.	**Process Improvements** ➢ Continue to pursue filling vacant positions ➢ Improve resource management ➢ Utilize internal experts to provide consistent guidance and training

Audit Work Group Issues

Issue	Response
Efficient conduct of audit, beginning and ending sooner. How can we aid or influence acceleration of audit start and end?	**Process Improvements** ➢ Reduce audit cycle time from 2-3+ years to 16 months ➢ Tailor audit methodology ➢ Enhance escalation process to enforce timely responses **OMT** ➢ Implements standard processes ➢ Employees status tracking and transparency – Expands case status categories – Establishes milestones and due dates ➢ Provides document sharing across offices ➢ Standardizes correspondence -data requests, preliminary determinations, order letters

Process Improvement Results

- **Audit**
  - Reduction of backlog
    - FY 17: 80% of audits over 3 years old completed
    - FY 18: 100% of audits over 3 years old scheduled for completion
  - Completion of new audit process pilot
    - Cycle times significantly reduced
  - Application of new audit process across AM
- **Compliance Reviews**
  - OMT implementation
    - Cycle times reduced by 20%
    - Prior to the process improvement project 20% of assignments resulted in findings
    - In FY 16: 40% of assignments resulted in findings

Questions