Rocky Mountain Mineral Law Foundation
2011 Federal Oil and Gas Leasing Short Course
October 17, 2011

Judith M. Matlock
Davis Graham & Stubbs LLP

Deborah Gibbs Tschudy
Office of Natural Resources Revenue

Outline of Presentation

- Introduction and Background (Debbie)
- Federal and Indian Gas Valuation (Judy)
- Federal and Indian Oil Valuation (Debbie)
- Enforcement and Resources (Judy)

Introduction

The Department of the Interior has administered the oil and gas leasing program for Federal and Indian lands for over 90 years. Responsibilities are divided among Department offices and bureaus:

- Office of Natural Resources Revenue (ONRR)
- Bureau of Ocean Energy Management (BOEM)
- Bureau of Safety and Environmental Enforcement (BSEE)
- Bureau of Land Management (BLM)
- Bureau of Indian Affairs (BIA)
- Office of Special Trustee (OST)

Reorganization of MMS

By Order dated May 19, 2010, Secretary Salazar restructured the Minerals Management Service into three new bureaus/offices:

Bureau of Ocean Energy Management (BOEM): A new bureau under the Assistant Secretary for Land and Minerals Management (ASLM) responsible for the sustainable development of the Outer Continental Shelf's conventional and renewable energy resources, including resource evaluation, planning, and other activities related to **leasing.**

Bureau of Safety and Environmental Enforcement (BSEE): A new bureau under ASLM responsible for ensuring comprehensive **oversight, safety, and environmental protection** in all offshore energy activities.

Office of Natural Resources Revenue (ONRR): A new office under the Assistant Secretary for Policy, Management, and Budget, responsible for the **royalty and revenue management** function including the collection and distribution of revenue, auditing and compliance, and asset management

Other DOI Bureaus and Offices

Bureau of Land Management (BLM): The Federal agency within DOI that is responsible for **onshore leasing** and related functions such as **drilling permits, production verification, diligence, onsite inspections, and enforcement**.

Bureau of Indian Affairs (BIA): Responsible for oversight of mineral leases on Indian lands, onsite compliance, appraising resources, and expert advice on drilling permits and other operational matters. BIA also **conducts oil and gas lease sales**, approves easements on trust lands, and **processes bi-monthly distribution of oil and gas royalties based on ONRR data**

Office of Special Trustee (OST): Established by the American Indian Trust Fund Management Reform Act of 1994. Provides DOI-wide oversight for the reform of Indian trust management and new fiduciary and accounting systems. **OST makes royalty payments to Indian mineral owners** based on availability of funds from ONRR and directions from BIA.

Statutory Authority

Interior's authority for leasing and collecting royalties from Federal lands comes from the following statutes:

- Mineral Leasing Act of 1920
- Indian Mineral Leasing Act of 1938
- Mineral Leasing Act for Acquired Lands of 1947
- Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA)
- Indian Mineral Development Act of 1982
- Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA)

Other statutes relevant to offshore leases:

- Outer Continental Shelf Lands Act of 1953
- Deepwater Royalty Relief Act of 1995
- Energy Policy Act of 2005
- Gulf of Mexico Energy Security Act of 2006 (GOMESA)

Regulations

ONRR – 30 C.F.R. § 1200

Contains rules and requirements for:

- Collecting rents, royalties, and other payments on Federal leased lands
- Determining royalty liability
- Maintaining accounting records
- Auditing royalty payments

Indian – 25 C.F.R. § § 211 – 212

Contains rules and requirements for:

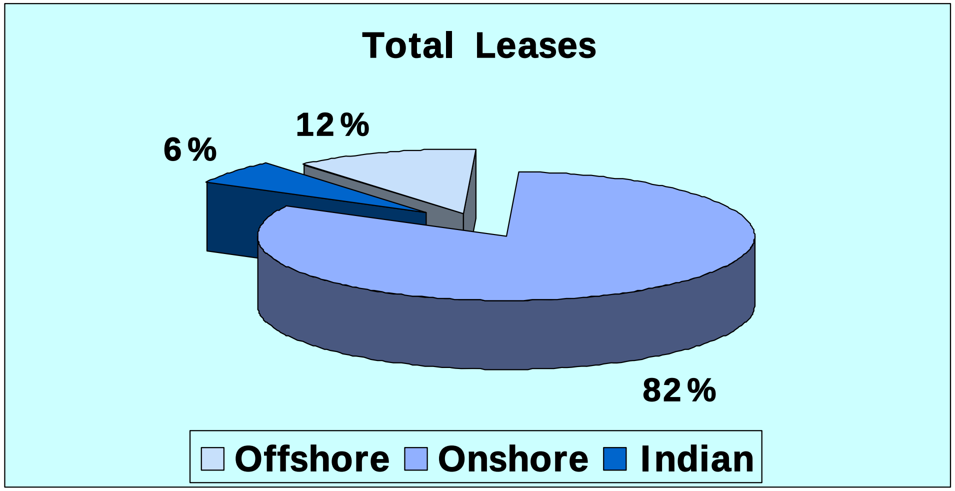
- Leasing oil, gas, and other minerals on tribal and allotted lands.
- Includes terms for rentals and royalties for leases

BLM – 43 C.F.R. § 3100

Contains rules and requirements for:

- Establishing BLM as leasing agent and ONRR for collecting rents and royalties on Federal lands
- Setting royalty rates

FY 2010 Mineral Leases

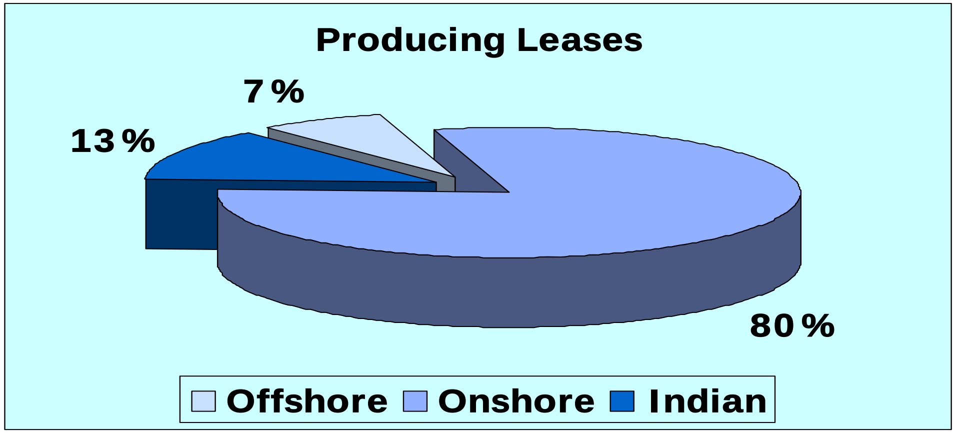


62,272 Total Leases

Offshore: 7,313*

Onshore: 50,316**

Indian: 4,643***



30,380 Producing Leases

Offshore: 1,821*

Onshore: 24,202**

Indian: 4,357***

*Administered by BOEM
**Administered by BLM
***Administered by BIA

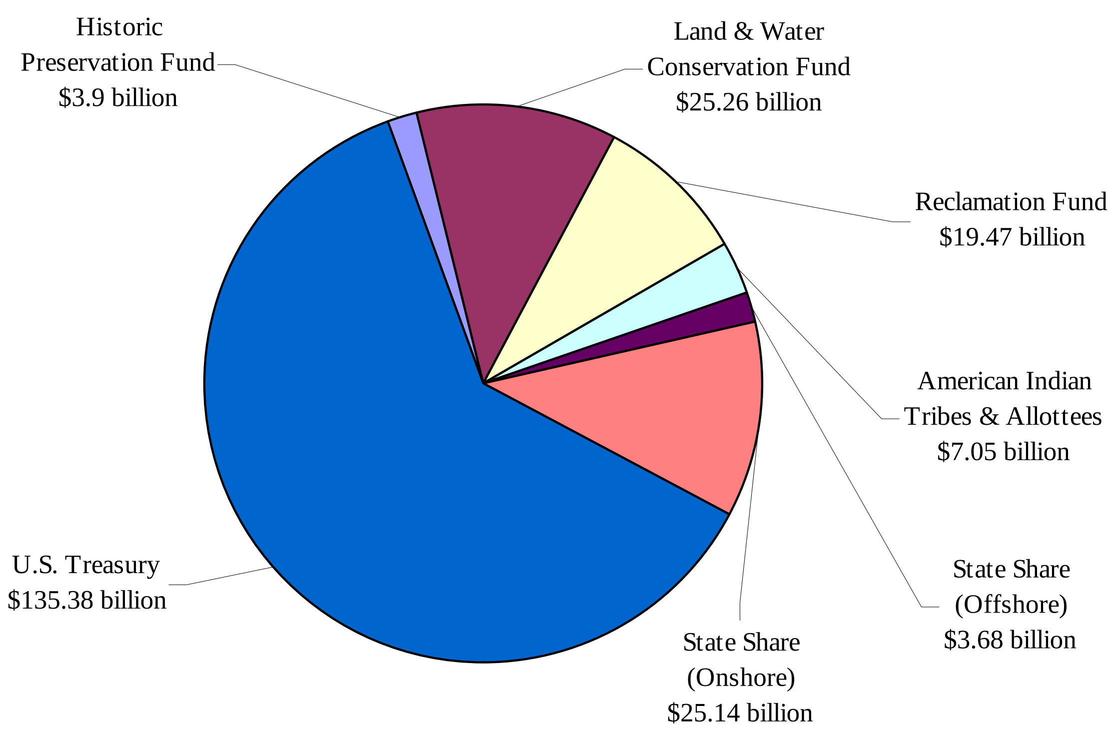
✓ Approximately $10 billion in revenue is disbursed annually

Federal and Indian Mineral Revenue Disbursements

FY 2010 Disbursements: $9.17 Billion

- $4.52 billion to the U.S. Treasury
- $899 million to the Land & Water Conservation Fund
- $150 million to the Historic Preservation Fund
- $1.36 billion to the Reclamation Fund
- $1.83 billion to 35 States
- $408 million to the Department's Office of the Special Trustee on behalf of 34 Indian tribes and approximately 30,000 individual Indians

FY 1982-2010 Cumulative Mineral Lease Revenue Disbursement ~ $219.86 Billion



- Since 1982, ONRR has distributed $219.86 billion in revenues from onshore and offshore lands to the Nation, States, and American Indians
- ONRR's distribution to the U.S. Treasury is one of the Federal government's greatest sources of non-tax income

Note: Rounding may affect totals

Who Receives the Revenues?

Offshore Federal Revenues

- 8(g) Leases: Lands within 3 miles of State seaward boundary
  - 27% to States; 73% to the U.S. Treasury
- Leases outside of 8(g) area:
  - Historically 100% to the United States Treasury
  - Portions of offshore revenues to special purpose funds (e.g., Historic Preservation, Land & Water Conservation)
- Leases subject to the Gulf of Mexico Energy Security Act, “qualified revenues” (cash bonuses, selected rentals, and royalties) are disbursed:
  - 50% to U.S. Treasury (General Fund)
  - 12.5% to Land and Water Conservation Fund
  - 37.5% Gulf Producing States and Coastal Political Subdivisions

Who Receives the Revenues?

***Onshore* Federal Revenues**

- 49 % shared with State where production occurs, except Alaska (89%)
- 40 % U.S. Treasury - Reclamation Fund
- 11 % U.S. Treasury - General Fund

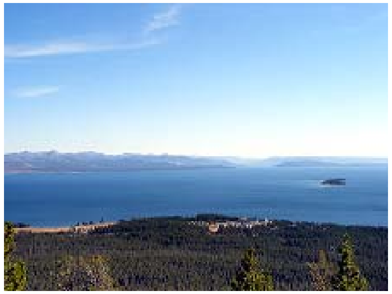
American Indian Tribes and Allottees

- 100% disbursed to Tribe or individual land owner

Special Purpose Funds

Land and Water Conservation Fund

- Enacted in 1964 thru Land and Water Conservation Fund Act.
- Funding source for both Federal, as well as grants to State and local governments, to help them acquire, develop, and improve outdoor recreation areas.
- Amounts transferred from ONRR to the NPS, the majority from royalties from Outer Continental Shelf.



Historic Preservation Fund

- Enacted in 1966 thru the National Historic Preservation Act.
- Funding grants serve as a catalyst and "seed money" to preserve and protect our Nation's irreplaceable heritage for current and future generations.
- Amounts transferred from ONRR to the NPS, the majority from royalties from Outer Continental shelf.

Special Purpose Funds

Reclamation Fund

- Enacted in 1902 thru the Reclamation Act.
- A restricted, unavailable receipt fund of deposits from a substantial portion of Reclamation's revenues and receipts from other Federal agencies.
- No expenditures are made directly from the Fund, however, funds are transferred pursuant to congressional appropriation acts to invest and reinvest in the reclamation of arid lands in the Western United States.

Coastal Impact Assistance Program (CIAP)

- Authorizes funds to be distributed to Outer Continental Shelf (OCS) oil and gas producing States to mitigate the impacts of OCS oil and gas activities.
- The Secretary was authorized to distribute to producing States and coastal political subdivisions (CPSs) $250 million for each of the fiscal years 2007 through 2010.
- Money was shared among six states and allocated to each producing State and eligible CPS based on allocation formulas prescribed by the Act.

Leasing Federal Lands for Mineral Development

- A Federal Mineral Lease grants to the "lessee" the exclusive right to explore for and develop the leased mineral resources.
- Lessee must timely explore for and develop the lease during the primary term of the lease and pay annual rent.
- Once a discovery is made and production of the mineral resource occurs, the lessee must pay a monthly production royalty (unless royalty relief applies).
- The lease remains in effect until the lessee ceases production or returns the lease.

Mineral Revenue Sources

Bonuses

- Cash consideration paid to United States by the successful bidder for a mineral lease

Rent

- Periodic payments made (until lease produces in paying quantities) by holder of a lease, during the primary lease term, for right to use the land or resources for purposes established in the lease

Royalties

- Based on Landowner’s share of the value of the minerals produced and sold
- Royalty rate is set in the lease document

General Lease Royalty Rates - Federal Onshore Leases

Oil & Gas, Onshore			
Royalty Rate	**Rent**	**Lease Duration**	**Bonus**
Competitive: Leases issued 12/22/87 forward: flat rate of 12.5% in amount or value of production. See 43 C.F.R. § 3103.3	After 12/22/87: $1.50/acre first 5 years, $2/acre subsequent years if extended.	10 years; continued so long as there is a well on the lease or unit capable of producing in commercial quantities.	Bonuses are based on fair market value, as determined by oral auction.
Leases issued under Mineral Leasing Act (Prior to 12/22/87), oil royalty assessed on production amount, ranges from 12.5% to 25%; gas royalty assessed on production amount, ranges from 12.5% to 16.67%.	Prior to 9/2/60: $0.25 - $1/acre; 9/2/60 – 12/22/87 $2/acre;		
Non-Competitive: Based on 12.5% in amount or value of production. See 43 C.F.R. § 3103.3	Prior to 9/2/60: $0.25 - $1 per acre; 9/2/60 – 2/1/77: $0.50 per acre; 2/1/77 – 12/22/87: $1 - $2/acre, $2/acre subsequent years. See 43 C.F.R. § 3103.2	10 years: continued so long as there is a well on the lease or unit capable of producing in commercial quantities.	However, all leases must be offered competitively FIRST

General Lease Royalty Rates - Federal Offshore Leases

Oil & Gas, Offshore			
Royalty Rate	**Rent**	**Lease Duration**	**Bonus**
Set for each sale area in the Final Notice of Sale. **Gulf of Mexico**: 18.75% **Alaska and other frontier areas:** 12.5% BOEM has the option to use other royalty rates of no less than 12.5 and other royalty systems such as sliding scale royalties, and other financial terms as prescribed in the OCSLA (e.g., net profit sharing). BOEM also uses royalty suspension programs (variable according to water depth for deep water royalty relief and depth of well for shallow water deep gas royalty relief) followed by the royalty rates listed above.	Set for each sale area in the Final Notice of Sale. **Gulf of Mexico:** - $7.00/acre/yr. in water depths < 200 meters and increasing to $14, $21, and $28/ acre in years 6, 7, and 8 respectively, when extensions are granted for ultra-deep gas drilling. - $11.00/acre for water depths of 200 to 400 meters and increasing to $22, $33, and $44/acre in years 6, 7, and 8 respectively, when extensions are granted for ultra-deep gas drilling. - $11/acre in water depths of > 400 meters with a single increase in the rental rate to $16 beginning in the sixth year of the lease. **Alaska:** Escalating rentals of $2.50/hectare in year 1; rising to $20/ hectare over the 10 year life of the lease.	Set for each sale area in the Final Notice of Sale. **Gulf of Mexico:** - 5 years in water depths less than 400 meters. - 5 years in water depths of 400 to less than 800 meters, with a 3-year extension if a well is commenced within the first 5 years. - 7 years in water depths of 400 to less than 800 meters, with a 3-year extension if a well is commenced within the first 7 years. - 10 years in water depths of 1600 meters or greater. **Alaska:** 10 years Production in paying quantities holds leases indefinitely beyond the primary lease term.	The bonus serves as the bid variable and must meet BOEM's fair market value criteria. Minimum bids are set for each sale area in the Final Notice of Sale: **Gulf of Mexico** Minimum bid of $25/ acre in water depths less than 400 meters and $37.50/ acre in water depths of 400 meters or greater. **Alaska:** Minimum of $37.50 per hectare. If a high bonus bid does not meet BOEM's fair market value criteria, it is rejected and the OCS block is reoffered at the next scheduled sale in the same planning area.

How Federal Royalties Are Calculated

<u>Royalty Calculation</u>

Royalty ($$) = Production Volume x Price x Royalty Rate

(Price = Gross Sales Value – Transportation - Processing Costs)

Example:

Lease production= 100 bbls, Price = $75, Transportation = $1.00, Royalty Rate = .125*

In Cash Royalty= 100 x ($75 - $1.00) x .125 = $925.00

***** Most Common Royalty Rates:

Onshore – 12.5%

Offshore – 18.75% for new leases

Royalty Valuation

- The Mineral Leasing Act of 1920 requires royalty on a percentage of **the amount or value of the production** removed or sold from the lease and authorizes the Secretary of Interior to adopt regulations to implement the statute.
- Through the public rulemaking process, the Secretary of the Interior reserves the authority to establish the value of production
- Separate oil and gas regulations exist for Federal and Indian leases and products.

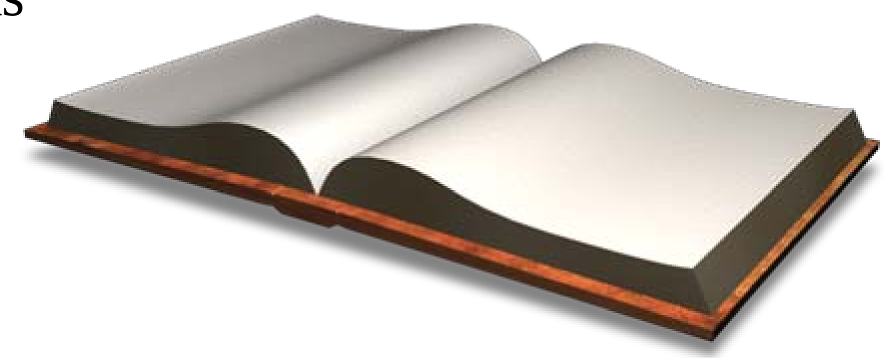
Royalty Valuation

- Royalty is generally owed on the gross proceeds accruing to the lessee less applicable allowances.
- Two allowances: transportation and processing.
- Costs of marketing and placing production into marketable condition are not deductable.
- Marketable condition means lease products which are sufficiently free from impurities and otherwise in a condition such that they will be accepted by a purchaser under a sales contract typical for the field or area.

Federal Gas Royalty Valuation

30 CFR 1206.150 to 30 CFR 1206.160 addresses:

- Establishing the value of production
- Determining authorized allowances for transportation and processing
- Exclusion of costs of marketing or placing gas into marketable condition
- Gross proceeds or benchmarks



Federal Gas Rule – Valuation Overview

Is the gas physically processed for the recovery of gas plant products

No

Yes

Is the gas sold prior to processing under an **arm's–length** contract, and the lessee retains no rights to the gas after the point of sale

Yes

No

Yes

Is the gas produced on or after Nov. 1, 1991 and the lessee's **arm's-length** contract for the sale of the gas prior to processing is a percentage-of-proceeds contract

Go to the unprocessed gas valuation standards 30 CFR 1206.152

No

Yes

Is the gas is processed, but the value is determined based on unprocessed gas under accounting for comparison requirements in 30 CFR 1206.155(a)

Yes

No

Is the gas sold prior to processing under a contract where the lessee retains the right to process the gas but the lessee does *not* exercise that right

No

Go to the processed gas valuation standards. See 30 CFR 1206.153

Conventional Gas Marketing Schematic

Wellhead

BLM approved point of measurement

Non-regulated (gathering) Pipeline

Gathering agreement – 15 cents/MMBTU; 2% fuel; condensate

Gas Processing Plant; liquids sales point

Processing agreement – 18 cents/MMBTU; plant use of gas as fuel

Interstate Pipeline

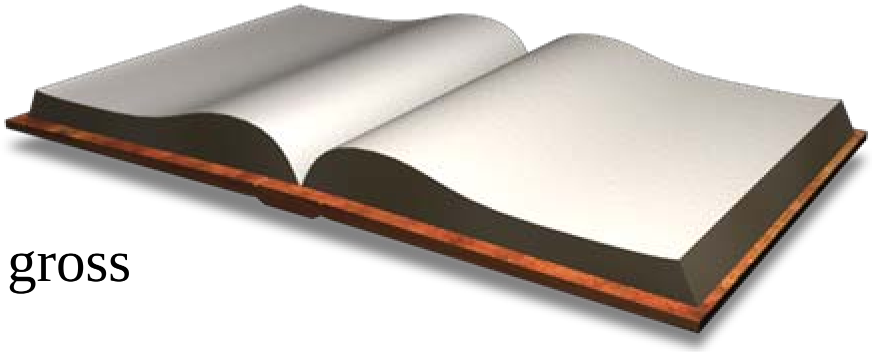
Transportation agreement – 32 cents/MMBTU plus 1.5% fuel

Residue Gas Sales Point

Indian Gas Royalty Valuation

30 CFR 1206.170 to 30 CFR 1206.181 addresses:

- Establishing the value of production
- Accounting for comparison
- Determining authorized allowances for transportation and processing
- Index-zone valuation
- Non-index zone leases - higher of gross proceeds or major portion value



Indian Gas Rule – Valuation Flowchart

Is your lease in an index zone and subject to index based valuation?

No → Go to non-index-based valuation (30 CFR 1206.174)

Value gas for arm's-length sales (gross proceeds) or for non-arm's length sales (benchmarks)

If the gas produced from your lease is processed, the value of the gas plant products must meet minimum value requirements

ONRR will determine the major portion value and due date and publish that information in the Federal Register

Adjust your royalties based on the higher of major portion value or value under the rules plus additional value for dual accounting, if applicable

Yes → Is gas from your lease sold beyond the first index pricing point through which the gas flows?

No → Apply the index-based value ($/MMBtu) for the zone that applies to my lease

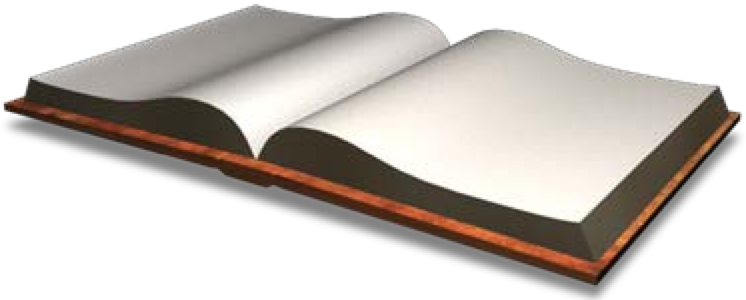
Report and pay royalties based on the index-based value plus additional value for dual accounting increment, if applicable

Yes → Safety net requirements apply, submit form ONRR-4411

Federal Oil Royalty Valuation

30 CFR 1206.100 to 30 CFR 1206.120 addresses:

- Establishing the value of production
- Federal oil not sold under an arm’s-length contract
  - Production from leases in California or Alaska
  - Production from leases in the Rocky Mountain Region
  - Production from leases not located in California, Alaska, or the Rocky Mountain Region (rest of the country)
- Determining location differentials and transportation allowances
- Exclusion of costs of marketing or placing oil into marketable condition
- Gross proceeds
- Sale or transfer to an affiliate



Federal Oil Rule – Valuation Flowchart

Did you or your affiliate sell the oil under an arm's-length contract?

Yes → Using 1206.102(a), value is the gross proceeds under the arm's length sale contract less applicable allowances

No ↓

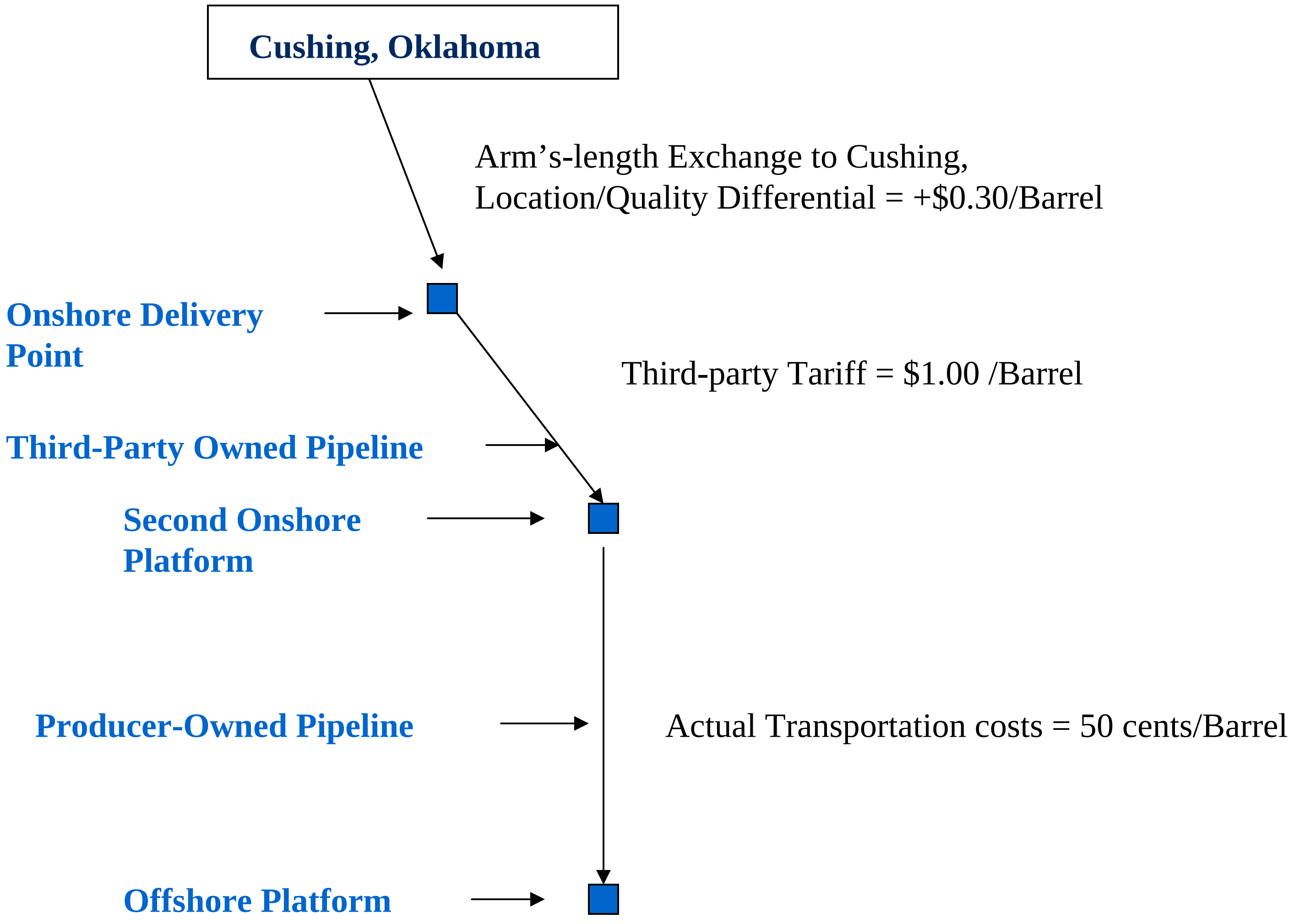
Was the oil sold or transferred under a non-arm's-length contract and then was resold under an arm's-length contract?

Yes → You may elect to value the production using either 1206.102 or 1206.103. You have to make the same election for all of your production and cannot change your election more often than once every 2 years

↑ Using 1206.102(a), value is the gross proceeds under the arm's length sale contract less applicable allowances

↓ Using 1206.103, value production from your area: California or Alaska, Rocky Mountain Region, or leases not located in California, Alaska, or Rocky Mountain Region

Oil Marketing Schematic



Federal Oil and Gas Valuation

Federal Oil and Gas Valuation - Advanced Notice of Proposed Rulemaking (ANPR)

- ONRR published an ANPR for Federal Oil and Gas Valuation on 5/27/2011
- Purpose: Simplify and further clarify valuation regulations
- Comment period closed on July 26, 2011

Public Meetings:

▪ Houston	Tuesday, September 27, 2011
▪ Washington, D.C.	Thursday, September 29, 2011
▪ Denver	Tuesday, October 4, 2011

Meeting Details: http://www.onrr.gov/Laws_R_D/FRNotices/FRNotices.htm

ANPR - Public Comments

- ONRR received responses from 19 commenters representing states, industry, industry trade associations and the general public.

  - ✓ 4 States
  - ✓ 8 Industry
  - ✓ 1 State Association
  - ✓ 4 Trade Groups
  - ✓ 1 Public Interest Group
  - ✓ 1 Pricing Publication
  - ✓ 0 Indian Tribes

Comments may be found at:

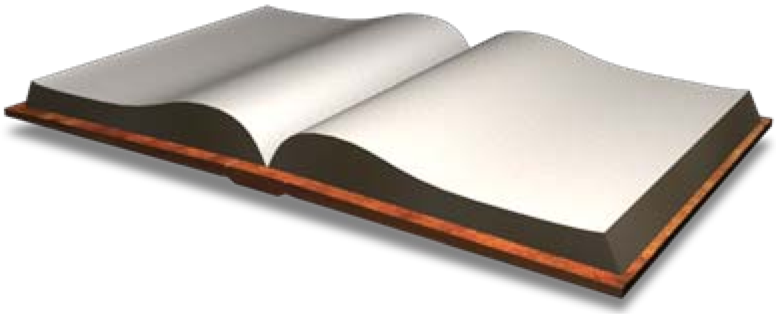
http://www.onrr.gov/Laws_R_D/PubComm/AA01rmpc.htm

- Based on the outcome of public meetings and review of comments, ONRR will consider publication of proposed regulations for public comment.

Indian Oil Royalty Valuation

30 CFR 1206.50 to 30 CFR 1206.55 addresses:

- Establishing the value of production. Higher of:
  - Gross proceeds (Arm's-Length)
  - Major portion value
- Determining authorized allowances for transportation
- Exclusion of costs of placing oil into marketable condition



Indian Oil Rule – Valuation Flowchart

Is the value of my production less than the major portion value?

Yes

The value of the production will be the major portion value

No

Is my oil sold under an arm's-length contract by my company or by my affiliate?

Yes

The value of oil which is sold under an arm's-length contract shall be the gross proceeds accruing to the lessee or the lessee's marketing affiliate

No

The unit value of oil not sold under an arm's-length contract is the volume-weighted average of the gross proceeds paid or received by you or your affiliate, including your refining affiliate, for purchases or sales under arm's-length contracts

Indian Oil Negotiated Rulemaking

Purpose: Advise the Secretary on a rulemaking to address Indian oil valuation as it relates to the major portion requirement in Indian oil and gas leases

- On August 22, 2011, ONRR published in the Federal Register a Second Notice of Intent to establish an Indian Oil Valuation Negotiated Rulemaking Committee
- Balanced membership from industry, Indian tribes and allottees, and the Federal government
- First meeting scheduled for February 2012

Enforcement

ONRR bills for late and underpaid royalties through its financial and audit and compliance program.

- Bills not paid timely subjected to extensive debt collection process
- ONRR has a comprehensive enforcement and penalty strategy to encourage prompt and accurate royalty reporting and payment
- Civil penalties can be applied to any type of noncompliance related to oil and gas leases
- Two separate schemes of civil penalties: penalties with a cure period, and those for knowing or willful violations

Enforcement

Violation Types

- Reporting failures[1] - failure to submit or correct monthly reports
- Unresolved variances[1] - reported volumes or values differ from expected amounts
- Payment violations[2] - failure to pay or repeated late payments
- Information refusal[2,3] - refusal to adequately fulfill data requests for audit, compliance review, etc.
- False information[2,3] - false information submitted in reports, letters, or documents

[1] Civil Penalties initially as much as $500-$5,000/violation/day (depending on duration of violation)
[2] Civil Penalties as much as $10,000-$25,000/violation/day (depending on type of violation)
[3] 5 years imprisonment/$250K fine provided by 18 U.S.C.§§ 1516, 1001

Appeals of ONRR Orders

- A lessee may appeal an order to pay or order to perform restructured accounting issued by ONRR or a delegated State concerning reporting or royalties due for Federal and Indian mineral leases (30 C.F.R. § 1290)
- Notice of Appeal (for Federal oil and gas leases) must be filed
  - within 30 days from service of the order to pay or
  - 60 days for an order to perform restructured accounting
- The ONRR Director renders decisions on Federal leases; Bureau of Indian Affairs (BIA) Director renders decisions on Indian leases
- The Assistant Secretary of Policy, Management and Budget and the Assistant Secretary of Indian Affairs may take jurisdiction of their respective appeals and issue final decisions

Appeals of ONRR Orders

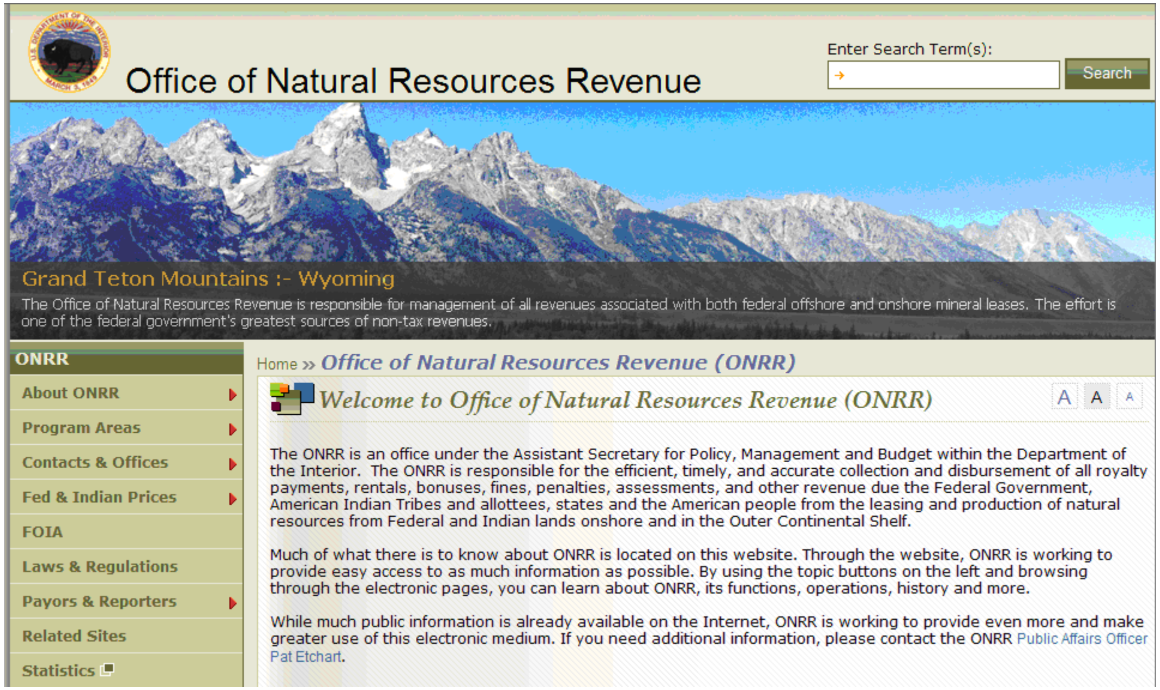
- Decisions by the ONRR Director or the BIA Director may be appealed to the Interior Board of Land Appeals (IBLA)
- Decisions by the IBLA may be appealed to District Court
- Final decisions issued by either the Assistant Secretary of Policy, Management and Budget or the Assistant Secretary of Indian Affairs may be appealed to District Court
- The Royalty Simplification and Fairness Act of 1996 (RSFA) requires that appeals on Federal oil and gas cases be addressed with a statutory decision within 33-months
- RSFA does not apply to solids minerals or Indian appeals

Resources

- Appendix A: Glossary
- Appendix B: Royalty Tables
- Appendix C: Reference List for Federal and Indian Oil and Gas Leasing Short Course
    - Statutes
    - Regulations
    - Federal and Indian Royalty Decisions
    - Dear Payor/Reporter Letters

Resources

- Appendix D: ONRR website http://www.onrr.gov/
  - Information and Contacts
  - Oil and Gas Prices
  - Laws and Regulations
  - Statistics
  - Links to Other Resources



Resources

- Appendix E: Rocky Mountain Mineral Law Foundation Resources