

sweet crude oil. For example, would it be useful to begin valuation of sour crude produced in the Rocky Mountain Region at Hardisty, Alberta, Canada (at which spot market prices for sour crude are published in trade publications), and adjust the Hardisty price for the cost of transportation from Casper, Wyoming (a typical delivery point) to Hardisty and from the lease to Casper? Because Hardisty is farther from Rocky Mountain market and refineries, MMS proposed that applicable transportation costs would be added to, rather than subtracted from, this market center's prices. MMS would like to better understand the number of companies for whom Hardisty would be an appropriate market center. Would it be better in such cases for the lessee to consult directly with MMS on the proper valuation procedure rather than MMS providing specifics in the rule?

C. What Adjustments and Transportation Allowances Apply When Valuing Production Using Index Pricing?—§ 206.112

MMS is proposing to revise the framework of how and when to apply location and quality differentials and transportation allowances in calculating royalty value. The current rules are based on the proposition that the value of oil not sold at arm's length can be accurately measured by known, accepted index prices at market centers. In order to accommodate certain transactions where the oil does not flow to a market center, the current rule allows lessees, in certain circumstances, to value the oil as if its value were the same at some alternative location (such as a refinery) as it would be at a market center. For example, the regulation currently provides that "if you transport lease production directly to * * * an alternate disposal point, you may adjust the index price for your actual transportation costs." 30 CFR § 206.112(c). However, value at a refinery may not be the same as the value at a market center.

To be sure that all royalty values are properly adjusted by market-based location and quality differentials (and transportation costs) to the NYMEX pricing point (Cushing), MMS is proposing to rewrite section 206.112. Proposed section 206.112 would clarify that if royalty value at the lease is calculated by starting with the NYMEX price, the NYMEX price would then be adjusted by applicable transportation costs or location and quality differentials between the lease and the market center, and then between the market center and Cushing.

Paragraph (a) of proposed section 206.112 would apply to that portion of the oil produced from your lease that is transported or exchanged (or both transported and exchanged) between the lease and the market center. Paragraphs (b) and (c) would apply to the remainder of your oil. Under paragraph (a), if you transport your oil over any segment (*i.e.*, between any two points) between the lease and the market center, you would determine a transportation allowance under either section 206.110 or 206.111. If you exchange your oil for any segment between the lease and the market center, you would use location and quality differentials derived from your arm's-length exchange agreements. (If an exchange agreement is not at arm's-length, you would have to obtain MMS approval for a location and quality adjustment. Until MMS approves a proposed location and quality differential, you would use the location and quality differential derived from your non-arm's-length exchange agreement. If MMS prescribes a different differential, you would have to adjust previously reported and paid royalties, together with appropriate interest payments or credits. If you do not have an arm's-length exchange agreement for your oil between the market center and Cushing, you would use the WTI differential to adjust for location and quality between the market center and Cushing. You could not both take a transportation allowance and apply a location and quality differential between the same two points.

For example, a lessee produces sour crude from a lease in the Gulf of Mexico that trades as Eugene Island (EI) crude. Assume that the lessee transports 35 percent of the oil produced from the lease to the market center at Houma, Louisiana. To determine the value of that 35 percent of the production, the lessee first would determine its transportation allowance from the lease to Houma under section 206.110 or 206.111, as applicable. In the alternative, if the lessee has an arm's-length exchange agreement between the lease and Houma, it would use the location and quality differential derived from that exchange agreement for the change in location covered by the exchange agreement. The lessee would adjust the NYMEX price by the transportation costs or the location and quality differential. If the lessee exchanges the oil under an arm's-length exchange agreement between Houma and Cushing, it would further adjust the NYMEX price by the location and quality differential derived from that agreement. Alternatively, if the lessee

did not exchange the oil between Houma and Cushing at arm's length, the lessee would adjust the NYMEX price by the published WTI-EI differential.

Paragraph (a) also addresses the situation in which the lessee both transports *and* exchanges a particular volume of oil from the lease to a market center. Therefore, assume the lessee transports 35 percent of the oil produced from the lease to Caillou Island and then exchanges that oil with another party at arm's length for Light Louisiana Sweet (LLS) at St. James, Louisiana, which is the LLS market center. To get the royalty value at Caillou Island, the lessee must add the differential in the exchange agreement (assume — \$1.00) to the market value of LLS, which is the NYMEX price plus the WTI-LLS differential (assume — \$.50). Assuming a NYMEX price of \$29.00, the value at Caillou Island would be \$27.50. The lessee may then subtract its transportation costs from the lease to Caillou Island (assume \$1.00) to determine the royalty value at the lease (a net value of \$26.50).

In the case of much of the crude oil produced from Federal leases in California, MMS anticipates that the market center would be Line 63 (for crude oil of like-quality to the crude oil for which Line 63 spot prices are published) or Kern River (for crude oil of like-quality to the crude oil for which Kern River spot prices are published). Therefore, to determine the adjusted NYMEX price for oil transported or exchanged to either of these market centers, the lessee would adjust the NYMEX price for the WTI differential between Cushing and the applicable market center.

Paragraph (b) or (c) of proposed section 206.112 applies when some, but not all of a lessee's oil is exchanged or transported to or through a market center. Paragraph (b) applies if the lessee transports or exchanges (or both transports and exchanges) at least 20 percent of the oil produced from the lease to a market center. In that event, the lessee would value that portion of the oil not transported or exchanged to a market center by the volume-weighted average of the values of the oil valued under paragraph (a). Therefore, in the preceding example, the lessee transported and exchanged 35 percent of its oil from the lease to the market center at St. James. The value of that oil calculated in that example was \$26.50/bbl. Assume that the lessee also transported another 45 percent of its oil from the lease to St. James, and that the adjusted NYMEX-based value of that oil was \$27.00/bbl. Finally, assume that the lessee transported the remaining 20