ONRR PROCESSED GAS REPORTING—COMMON VALIDATION ERRORS AND HOW TO RESOLVE THEM

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On July 1, 2016, the Office of Natural Resources Revenue (ONRR) published the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform Rule, 81 Fed. Reg. 43,338 (2016 Valuation Rules). The effective date of the rules was January 1, 2017. The 2016 Valuation Rules subsequently went on a very bumpy ride. First they were postponed, then repealed, and then reinstated with the original effective date of January 1, 2017. Lessees have until October 1, 2020, to make any necessary corrections to their royalty valuation and reporting back to the January 2017 production month and to be able to report under the rules on a going forward basis.

Perhaps the most administratively burdensome requirement of the 2016 Valuation Rules is the requirement changing how royalties on most federal gas production sold prior to processing are to be reported. Under the prior regulations, if federal gas production was sold in an arm's-length transaction prior to processing, the unprocessed gas valuation regulations applied. 30 C.F.R. § 1206.152(a) (2016). From a reporting standpoint, this meant that a federal lessee only needed to report a product code 04 (unprocessed gas) single line on the Form ONRR-2014 for each lease (or each lease and agreement combination). That line would report the volume and MMBtus of the gas as measured at the BLM point of royalty settlement and the sales value as calculated under the unprocessed gas regulations. If the point of sale was off the lease, a transportation allowance could also be reported.

Under the 2016 Valuation Rules, if the sales contract provides for payment "to be determined on the basis of the value of any products resulting from processing, including residue gas or natural gas liquids," then processed gas reporting is required. 30 C.F.R. § 1206.142(a)(2). All percentage of proceeds (POP) and percentage of index sales contracts fit this definition and historically those types of contracts have been the predominant type of wellhead sales contract in the industry.

Overnight, the majority of federal lessees were subject to having to do processed gas reporting. Instead of reporting a single product code 04 line, these lessees must now report at least three lines per lease (or lease/agreement combination): a product code 03 line (residue gas and disallowed plant fuel at a minimum);[1] product code 07 (natural gas liquids);[2] and product code 15 (field fuel and lost and unaccounted for volumes between the wellhead and the plant).[3] In some cases separate lines are also required for product code 05 (drip liquids) and/or product code 06 (plant inlet scrubber condensate).

The accounting programs or spreadsheets unprocessed gas reporters have are designed for product code 04 reporting. Some companies have purchased new software programs only to discover that they cannot perform the calculations and prepare the federal royalty reports required by the 2016

[1] See fn.2 in the Dear Reporter Letter dated December 18, 2014, https://www.onrr.gov/PDFDocs/20141218.pdf. Plant flare and plant lost and unaccounted for quantities are also reported with PC 03.

[2] The 2016 Valuation Rules require that if the liquids prices on the plant statement have been reduced by any liquids transportation, fractionation or other costs (such as storage or marketing fees), the grossed up liquids prices must be used to calculate the product code 07 Sales Value. Then liquids transportation may be included in the transportation allowance (subject to the allowance cap) and liquids fractionation may be included in the processing allowance (subject to the processing allowance cap).

[3] Dear Reporter Letter dated December 18, 2014.

Valuation Rules. Companies have been designing their own spreadsheet workbooks to meet the implementation and correction deadline.

Some of these new processed gas reporters have run into difficulties getting their royalty reports through the ONRR validation process which is designed to catch certain reporting errors before royalty reports can be accepted into the ONRR system. This article addresses some of the more common validation errors associated with processed gas reporting and how to resolve them.

Error Code 9751-Allowance Exceeds Regulation Limit

There are two allowance limits under the 2016 Valuation Rules. These are carryovers of allowance limits under the prior regulations. The allowance limits are calculated by the ONRR system on the royalty level, i.e., by comparison of the amount reported in the Royalty Value Prior to Allowances (RVPA) field to any allowances reported.

The first allowance limit is the transportation allowance. For each product code reported, the transportation allowance is the *lesser of* the actual unbundled[4] transportation costs allocated to that product code or 50% of the reported Sales Value for the product code.[5] If the Sales Value of Product Code 03 is $800, the RVPA under a lease with a 12.5% royalty rate will be $100.00. The transportation allowance allocated to Product Code 03 then cannot be greater than $50.00 *by even a fraction of a penny*.

Under a traditional percentage of proceeds contract, the transportation allowance limit does not typically come into play. But under more recent forms of POP contracts, there can be fixed fees, including gathering and processing fees in addition to the plant retaining a percentage of the proceeds from the sale of residue gas and liquids. In a low commodity price environment, allowance limits are much more likely to be triggered.

If actual unbundled transportation costs are greater than the 50% limit and you are not attempting to deduct more than the 50% limit, you can still get this error message. If a line on the royalty report with this error message looks correct, temporarily expand the number of decimals in the cells in the line to three or four decimals or more to see if the amount being deducted is over the limit by a fraction of a penny when you can see more decimals. In the above example, you might find that the expanded transportation allowance you were attempting to upload is $50.01.[6] That is why the error message was triggered.

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[4] The term "unbundled" refers to determining the portion of transportation and processing costs deducted by a purchaser that were for services necessary to put gas into marketable condition. For example, if a plant charges $0.30 to transport gas from the wellhead to the plant and that charge includes both the delivery service and field compression to 300 psig, the portion of the $0.30 attributable to the field compression is a disallowed marketable condition cost. The $0.30 charge must be "unbundled" into the allowed delivery service component and the disallowed marketable condition service component. Lessees must either (1) come up with their own reasonable and documented unbundling, (2) use the unbundling cost allowances (UCAs) ONRR has on its website for some gas plants and transportation systems or one of ONRR's standardized UCAs if applicable, or (3) take no allowances. Costs that must be unbundled include, but are not limited to, the value of any residue gas and liquids retained by a plant as consideration under a percentage of proceeds contract and fees charged for bundled services.

[5] The 50% limit is a maximum, not a minimum. If the actual unbundled transportation costs are less than the 50% limit, then only the actual unbundled transportation costs may be deducted.

[6] ONRR training slides use an example of a RVPA of $123.45 and a transportation allowance of $61.73. This will trigger the Error Code because 61.73 is 50.000405% of 123.45.

You can avoid triggering this error message by (1) calculating the allowance caps on the royalty level (i.e., after tract factors and the lease royalty rate have been applied) and (2) using the roundup formula (to two decimals) to report the RVPA, the rounddown formula (to two decimals) to report the Transportation Allowance, and the sum formula to calculate the Royalty Value After Allowances (RVAA).

The second allowance limit is on the processing allowance which can be deducted only against the value of the liquids (reported as product code 07).[7] The regulations, both before and with the 2016 Valuation Rules, provide that the processing allowance may not exceed "66 2/3 percent of the value of each gas plant product."[8] ONRR considers natural gas liquids (NGLs) to be one product.[9] Critically, the regulations go on to provide that before calculating the 66 2/3 limit, "you must first reduce the value for any transportation allowances related to *post-processing* transportation authorized under § 1206.152."[10] [Emphasis added.] It is this last requirement that is often the cause of an Error Code 9751.

The phrase "post-processing transportation" refers to transportation of NGLs from the plant to a fractionation facility. In contrast, pre-processing transportation is the allocated unbundled share of transportation from the wellhead to the gas plant. The processing allowance can be calculated correctly under the regulations and a product code 07 line on the royalty report can be rounded up, rounded down, and summed as described above, and still Error Code 9751 can be triggered. This is because pre-processing and post-processing transportation costs are reported as a single total in the Transportation Allowance field on the royalty report. The ONRR system cannot tell how much of the reported Transportation Allowance is for pre-processing transportation and how much is for post-processing transportation. Therefore, the up-front edit that checks for allowances exceeding limits calculates the processing allowance limit by subtracting 100% of the reported Transportation Allowance from the RVPA and the 66 2/3% limit is then calculated on the remainder.

Suppose the RVPA for product code 07 is $200 and a lessee incurs $40.00 of unbundled transportation costs for transportation of the NGL component of the gas stream to the gas plant and $20.00 of transportation costs to transport the NGLs to a fractionation facility. The reporting on the royalty level would look like this:

RVPA	Transp	Processing	RVAA
200.00	60.00	115.00	25.00

This would trigger Error Code 9751 because the ONRR system will calculate a processing allowance limit of $93.32 as follows:

RVPA	200.00
Transp	60.00
Net	140.00
Times	66.66%
Equals	93.32

[7] No part of the unbundled processing costs can be allocated to product codes 03 or 15. No processing allowance can be taken for scrubber condensate handling and stabilization. (Condensate removed in a plant by refrigeration is eligible for a processing allowance because a refrigeration process was used to remove the condensate.)
[8] 30 C.F.R. § 1206.159(c)(2).
[9] 30 C.F.R. § 1206.159(a)(2)(b).
[10] Id. The 66 2/3% limit is a maximum, not a minimum. If the actual unbundled processing costs are less than the 66 2/3% limit, then only the actual unbundled processing costs may be deducted.

The correct calculation under the regulations is a processing allowance limit of $119.99 calculated as follows:

RVPA	200.00
Transp	20.00
Net	180.00
Times	66.66%
Equals	119.99

The processing allowance reported on the line that triggered the error code is greater than the ONRR-system calculated limit of $93.32 but less than the actual processing allowance limit under the regulations of $119.99.

In this situation, you cannot clear the "error" yourself (other than to give up the portion of the allowance in excess of the ONRR-system calculated limit); an override of the error from ONRR is required. In order to get the override, you must be able to show the portion of the transportation allowance that is for post-processing transportation. For example, if the liquids were transported to Mont Belvieu, Texas, for fractionation and, therefore, you used the liquids transportation rate in the FERC Tariff of the applicable liquids pipeline to calculate the post-processing transportation allowance, then be prepared to furnish the tariff (available from the FERC eLibrary, show your calculation of the rate per gallon (most tariffs rates are per barrel)), and show your calculation of the processing allowance limit applying the regulations.

<u>Error Code 9740 - Combined allowances exceed 99% of the RVPA</u>

This error code is limited to product code 07 lines because only product code 07 has two allowances: transportation and processing. This error code is triggered when the sum of the transportation and processing allowances exceeds 99% of the RVPA. Until quite recently, this limit was seldom triggered. But under more recently negotiated POP contracts with fixed fees, combined with the downturn in commodity prices, this error code can be triggered.

The first step to resolving this error code is to make certain that the RVPA was rounded up (to two decimal places), each allowance was rounded down (to two decimal places), and the RVAA is calculated by the sum function. If, after this rounding and summing, the RVAA is still less than 99% of the RVPA, to clear this error the allowances (or one of them) will have to be reduced so that the RVAA is not less than 99% of the RVPA.

<u>Error Code 9613 - Fed Gas MMBTU Val/Vol not within price limits for specified Product</u>

This Error Code is triggered if the price per MMBtu for any product code for which Gas MMBtu is reported (product codes 03 and 15) is less than a minimum range or greater than a maximum range established by ONRR. The price per MMBtu is calculated by the ONRR system by dividing the Sales Value by the Gas MMBtu.

The purpose of this Error Code is to keep lessees from making a mistake in reporting. For example, if the price per MMBtu received by a lessee was $1.50 and the lessee sold 100 MMBtus of residue gas, the reported Gas MMBtu should be 100.00 and the reported Sales Value should be 150.00. However, suppose the lessee made a mistake with its decimal point and reported a Sales Value of 15.00. In that instance, this Error Code would be triggered because the apparent "price" would be $0.15 per MMBtu which would be outside the minimum range. This Error Code would also be triggered if the lessee made a mistake and reported a Sales Value of 1500.00 which would be an apparent "price" of $15.00 per MMBtu.

This Error Code is not intended to and does not establish a mandatory minimum value. But this Error Code can be triggered simply because actual residue prices fall below the ONRR minimum range. This became a significant issue for federal lessees in the Permian Basin in 2019. This Error Code affects not only product code 03 lines but also product code 15 lines because lessees use their residue gas prices to value product code 15. The only way to clear this Error Code is to request an override and be prepared to provide proof of the price actually received.

Negative prices

In 2019, producers began to experience negative residue prices in some regions. The ONRR system will not allow the reporting of negatives values. Temporarily, lessees had to manually gross up to a penny in order to be able to submit their royalty reports. ONRR responded by making an adjustment to its system to allow the reporting of the actual Sales Volume and Gas MMBtu but with 0.00 values for the remaining fields[11] by using transaction code 20 in lieu of transaction code 01. In order to be able to use transaction code 20, your specific circumstances must meet the following conditions:

1. You are valuing federal gas for royalty purposes. Transaction code 20 does not apply to Indian gas valuation.

2. Your sales contract is an arm's-length sales contract. The contract must include a provision under which the price you are paid is based on a negative price. And, when you add back all disallowed costs and additional consideration,[12] your value for royalty purposes is still less than or equal to zero.

3. Transaction code 20 can also be used if you are valuing production using the Index-based option under the 2016 Valuation Rules (effective with January 2017 production and subsequent months) and the highest reported monthly bidweek price for the index pricing points to which your gas could be transported for the production month, whether or not there are constraints, is less than or equal to zero.

Some producers are now experiencing negative liquids prices. If some of the liquids prices are negative but the total liquids value is positive, there is not an issue because ONRR considers liquids to be a single product for federal gas valuation and reporting. Even if the total liquids value reported on a statement is negative, the value for purposes of the 2016 Valuation Rules may still be positive because of the elimination of transportation factors under the 2016 Valuation Rules. As already noted, lessees are now required to gross up the liquids prices on their statements by any post-processing liquids transportation and fractionation costs (as well as any marketing fees and storage costs) that were deducted from the prices reported on the statement. Transaction Code 20 is not currently designed for the situation in which the total value of the liquids is still negative after grossing up by these amounts.

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[11] The other fields are Sales Value, Royalty Value Prior to Allowances, Transportation Allowance, Processing Allowance, and Royalty Value Less Allowances.

[12] For example, if the contract price is negative because the purchaser subtracted a marketing fee (a disallowed cost), you must add back the disallowed cost for royalty reporting purposes.

Advance copies of a new Notice of Proposed Rulemaking (the "NOPR") are currently circulating but have not yet been published in the Federal Register. The NOPR is proposing amendments to some of the 2016 Valuation Rules. It can be expected that there will be as much litigation around any amendments that are adopted as there has been concerning the 2016 Valuation Rules. It will be critical for industry to comment with as much detail and specifics as possible about the proposed amendments they support as well as those they oppose. One provision that is not proposed for amendment is the requirement to do processed gas reporting for gas sold under POP contracts. Thus, avoiding and eliminating validation errors associated with processed gas reporting will continue to be important.