

arrangement shall not exceed 50 percent of the value of the residue gas or gas plant product determined in accordance with § 206.153 of this subpart. For purposes of this section, natural gas liquids shall be considered one product.

(3) Upon request of a lessee, MMS may approve a transportation allowance deduction in excess of the limitations prescribed by paragraphs (c)(1) and (c)(2) of this section. The lessee must demonstrate that the transportation costs incurred in excess of the limitations prescribed in paragraphs (c)(1) and (c)(2) of this section were reasonable, actual, and necessary. An application for exception (using Form MMS-4393, Request to Exceed Regulatory Allowance Limitation) shall contain all relevant and supporting documentation necessary for MMS to make a determination. Under no circumstances shall the value for royalty purposes under any selling arrangement be reduced to zero.

(d) If, after a review and/or audit, MMS determines that a lessee has improperly determined a transportation allowance authorized by this subpart, then the lessee shall pay any additional royalties, plus interest, determined in accordance with 30 CFR 218.54, or shall be entitled to a credit, without interest. If the lessee takes a deduction for transportation on the Form MMS-2014 by improperly netting the allowance against the sales value of the unprocessed gas, residue gas, and gas plant products instead of reporting the allowance as a separate line item, he may be assessed an additional amount under 206.157(d).

[53 FR 1272, Jan. 15, 1988, as amended at 61 FR 5465, Feb. 12, 1996; 64 FR 43288, Aug. 10, 1999]

§ 206.157 Determination of transportation allowances.

(a) *Arm's-length transportation contracts.* (1)(i) For transportation costs incurred by a lessee under an arm's-length contract, the transportation allowance shall be the reasonable, actual costs incurred by the lessee for transporting the unprocessed gas, residue gas and/or gas plant products under that contract, except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of

this section, subject to monitoring, review, audit, and adjustment. The lessee shall have the burden of demonstrating that its contract is arm's-length. MMS' prior approval is not required before a lessee may deduct costs incurred under an arm's-length contract. Such allowances shall be subject to the provisions of paragraph (f) of this section. The lessee must claim a transportation allowance by reporting it as a separate line entry on the Form MMS-2014.

(ii) In conducting reviews and audits, MMS will examine whether or not the contract reflects more than the consideration actually transferred either directly or indirectly from the lessee to the transporter for the transportation. If the contract reflects more than the total consideration, then the MMS may require that the transportation allowance be determined in accordance with paragraph (b) of this section.

(iii) If the MMS determines that the consideration paid pursuant to an arm's-length transportation contract does not reflect the reasonable value of the transportation because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the transportation allowance be determined in accordance with paragraph (b) of this section. When MMS determines that the value of the transportation may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's transportation costs.

(2)(i) If an arm's-length transportation contract includes more than one product in a gaseous phase and the transportation costs attributable to each product cannot be determined from the contract, the total transportation costs shall be allocated in a consistent and equitable manner to each of the products transported in the same proportion as the ratio of the volume of each product (excluding waste products which have no value) to the volume of all products in the gaseous phase (excluding waste products which have no value). Except as provided in this paragraph, no allowance may be taken for the costs of transporting

lease production which is not royalty bearing without MMS approval.

(ii) Notwithstanding the requirements of paragraph (i), the lessee may propose to MMS a cost allocation method on the basis of the values of the products transported. MMS shall approve the method unless it determines that it is not consistent with the purposes of the regulations in this part.

(3) If an arm's-length transportation contract includes both gaseous and liquid products and the transportation costs attributable to each cannot be determined from the contract, the lessee shall propose an allocation procedure to MMS. The lessee may use the transportation allowance determined in accordance with its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all relevant data to support its proposal. MMS shall then determine the gas transportation allowance based upon the lessee's proposal and any additional information MMS deems necessary. The lessee must submit the allocation proposal within 3 months of claiming the allocated deduction on the Form MMS-2014.

(4) Where the lessee's payments for transportation under an arm's-length contract are not based on a dollar per unit, the lessee shall convert whatever consideration is paid to a dollar value equivalent for the purposes of this section.

(5) Where an arm's-length sales contract price or a posted price includes a provision whereby the listed price is reduced by a transportation factor, MMS will not consider the transportation factor to be a transportation allowance. The transportation factor may be used in determining the lessee's gross proceeds for the sale of the product. The transportation factor may not exceed 50 percent of the base price of the product without MMS approval.

(b) *Non-arm's-length or no contract.* (1) If a lessee has a non-arm's-length transportation contract or has no contract, including those situations where the lessee performs transportation services for itself, the transportation allowance will be based upon the lessee's reasonable actual costs as pro-

vided in this paragraph. All transportation allowances deducted under a non-arm's-length or no contract situation are subject to monitoring, review, audit, and adjustment. The lessee must claim a transportation allowance by reporting it as a separate line entry on the Form MMS-2014. When necessary or appropriate, MMS may direct a lessee to modify its estimated or actual transportation allowance deduction.

(2) The transportation allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for transportation during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial depreciable investment in the transportation system multiplied by a rate of return in accordance with paragraph (b)(2)(iv)(B) of this section. Allowable capital costs are generally those costs for depreciable fixed assets (including costs of delivery and installation of capital equipment) which are an integral part of the transportation system.

(i) Allowable operating expenses include: Operations supervision and engineering; operations labor; fuel; utilities; materials; ad valorem property taxes; rent; supplies; and any other directly allocable and attributable operating expense which the lessee can document.

(ii) Allowable maintenance expenses include: Maintenance of the transportation system; maintenance of equipment; maintenance labor; and other directly allocable and attributable maintenance expenses which the lessee can document.

(iii) Overhead directly attributable and allocable to the operation and maintenance of the transportation system is an allowable expense. State and Federal income taxes and severance taxes and other fees, including royalties, are not allowable expenses.

(iv) A lessee may use either depreciation or a return on depreciable capital investment. After a lessee has elected to use either method for a transportation system, the lessee may not later

elect to change to the other alternative without approval of the MMS.

(A) To compute depreciation, the lessee may elect to use either a straight-line depreciation method based on the life of equipment or on the life of the reserves which the transportation system services, or a unit of production method. After an election is made, the lessee may not change methods without MMS approval. A change in ownership of a transportation system shall not alter the depreciation schedule established by the original transporter/lessee for purposes of the allowance calculation. With or without a change in ownership, a transportation system shall be depreciated only once. Equipment shall not be depreciated below a reasonable salvage value.

(B) The MMS shall allow as a cost an amount equal to the allowable initial capital investment in the transportation system multiplied by the rate of return determined pursuant to paragraph (b)(2)(v) of this section. No allowance shall be provided for depreciation. This alternative shall apply only to transportation facilities first placed in service after March 1, 1988.

(v) The rate of return must be the industrial rate associated with Standard and Poor's BBB rating. The rate of return must be the monthly average rate as published in Standard and Poor's Bond Guide for the first month for which the allowance is applicable. The rate must be redetermined at the beginning of each subsequent calendar year.

(3)(i) The deduction for transportation costs shall be determined on the basis of the lessee's cost of transporting each product through each individual transportation system. Where more than one product in a gaseous phase is transported, the allocation of costs to each of the products transported shall be made in a consistent and equitable manner in the same proportion as the ratio of the volume of each product (excluding waste products which have no value) to the volume of all products in the gaseous phase (excluding waste products which have no value). Except as provided in this paragraph, the lessee may not take an allowance for transporting a product

which is not royalty bearing without MMS approval.

(ii) Notwithstanding the requirements of paragraph (b)(3)(i), the lessee may propose to the MMS a cost allocation method on the basis of the values of the products transported. MMS shall approve the method unless it determines that it is not consistent with the purposes of the regulations in this part.

(4) Where both gaseous and liquid products are transported through the same transportation system, the lessee shall propose a cost allocation procedure to MMS. The lessee may use the transportation allowance determined in accordance with its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all relevant data to support its proposal. MMS shall then determine the transportation allowance based upon the lessee's proposal and any additional information MMS deems necessary. The lessee must submit the allocation proposal within 3 months of claiming the allocated deduction on the Form MMS-2014.

(5) A lessee may apply to the MMS for an exception from the requirement that it compute actual costs in accordance with paragraphs (b)(1) through (b)(4) of this section. The MMS will grant the exception only if the lessee has a tariff for the transportation system approved by the Federal Energy Regulatory Commission (FERC) (for both Federal and Indian leases) or a State regulatory agency (for Federal leases). The MMS shall deny the exception request if it determines that the tariff is excessive as compared to arm's-length transportation charges by pipelines, owned by the lessee or others, providing similar transportation services in that area. If there are no arm's-length transportation charges, MMS shall deny the exception request if: (i) No FERC or State regulatory agency cost analysis exists and the FERC or State regulatory agency, as applicable, has declined to investigate pursuant to MMS timely objections upon filing; and (ii) the tariff significantly exceeds the lessee's actual costs for transportation as determined under this section.

(c) *Reporting requirements.* (1) *Arm's-length contracts.* (i) The lessee must notify MMS of an allowance based on incurred costs by using a separate line entry on the Form MMS-2014.

(ii) The MMS may require that a lessee submit arm's-length transportation contracts, production agreements, operating agreements, and related documents. Documents shall be submitted within a reasonable time, as determined by MMS.

(2) *Non-arm's-length or no contract.* (i) The lessee must notify MMS of an allowance based on the incurred costs by using a separate line entry on the Form MMS-2014.

(ii) For new transportation facilities or arrangements, the lessee's initial deduction shall include estimates of the allowable gas transportation costs for the applicable period. Cost estimates shall be based upon the most recently available operations data for the transportation system or, if such data are not available, the lessee shall use estimates based upon industry data for similar transportation systems.

(iii) Upon request by MMS, the lessee shall submit all data used to prepare the allowance deduction. The data shall be provided within a reasonable period of time, as determined by MMS.

(iv) If the lessee is authorized to use its FERC-approved or State regulatory agency-approved tariff as its transportation cost in accordance with paragraph (b)(5) of this section, it shall follow the reporting requirements of paragraph (c)(1) of this section.

(d) *Interest and assessments.* (1) If a lessee nets a transportation allowance against the royalty value on the Form MMS-2014, the lessee shall be assessed an amount of up to 10 percent of the allowance netted not to exceed \$250 per lease selling arrangement per sales period.

(2) If a lessee deducts a transportation allowance on its Form MMS-2014 that exceeds 50 percent of the value of the gas transported without obtaining prior approval of MMS under § 206.156, the lessee shall pay interest on the excess allowance amount taken from the date such amount is taken to the date the lessee files an exception request with MMS.

(3) If a lessee erroneously reports a transportation allowance which results in an underpayment of royalties, interest shall be paid on the amount of that underpayment.

(4) Interest required to be paid by this section shall be determined in accordance with 30 CFR 218.54.

(e) *Adjustments.* (1) If the actual transportation allowance is less than the amount the lessee has taken on Form MMS-2014 for each month during the allowance reporting period, the lessee shall be required to pay additional royalties due plus interest computed under 30 CFR 218.54 from the allowance reporting period when the lessee took the deduction to the date the lessee repays the difference to MMS. If the actual transportation allowance is greater than the amount the lessee has taken on Form MMS-2014 for each month during the allowance reporting period, the lessee shall be entitled to a credit without interest.

(2) For lessees transporting production from onshore Federal leases, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with any payment, in accordance with instructions provided by MMS.

(3) For lessees transporting gas production from leases on the OCS, if the lessee's estimated transportation allowance exceeds the allowance based on actual costs, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with its payment, in accordance with instructions provided by MMS. If the lessee's estimated transportation allowance is less than the allowance based on actual costs, the refund procedure will be specified by MMS.

(f) *Allowable costs in determining transportation allowances.* Lessees may include, but are not limited to, the following costs in determining the arm's-length transportation allowance under paragraph (a) of this section or the non-arm's-length transportation allowance under paragraph (b) of this section:

(1) *Firm demand charges paid to pipelines.* You must limit the allowable costs for the firm demand charges to

the applicable rate per MMBtu multiplied by the actual volumes transported. You may not include any losses incurred for previously purchased but unused firm capacity. You also may not include any gains associated with releasing firm capacity. If you receive a payment or credit from the pipeline for penalty refunds, rate case refunds, or other reasons, you must reduce the firm demand charge claimed on the Form MMS-2014. You must modify the Form MMS-2014 by the amount received or credited for the affected reporting period;

(2) *Gas supply realignment (GSR) costs.* The GSR costs result from a pipeline reforming or terminating supply contracts with producers to implement the restructuring requirements of FERC Orders in 18 CFR part 284;

(3) *Commodity charges.* The commodity charge allows the pipeline to recover the costs of providing service;

(4) *Wheeling costs.* Hub operators charge a wheeling cost for transporting gas from one pipeline to either the same or another pipeline through a market center or hub. A hub is a connected manifold of pipelines through which a series of incoming pipelines are interconnected to a series of outgoing pipelines;

(5) *Gas Research Institute (GRI) fees.* The GRI conducts research, development, and commercialization programs on natural gas related topics for the benefit of the U.S. gas industry and gas customers. GRI fees are allowable provided such fees are mandatory in FERC-approved tariffs;

(6) *Annual Charge Adjustment (ACA) fees.* FERC charges these fees to pipelines to pay for its operating expenses;

(7) *Payments (either volumetric or in value) for actual or theoretical losses.* This paragraph does not apply to non-arm's-length transportation arrangements unless the transportation allowance is based on a FERC or State regulatory-approved tariff;

(8) *Temporary storage services.* This includes short duration storage services offered by market centers or hubs (commonly referred to as "parking" or "banking"), or other temporary storage services provided by pipeline transporters, whether actual or provided as a matter of accounting. Temporary

storage is limited to 30 days or less; and

(9) *Supplemental costs for compression, dehydration, and treatment of gas.* MMS allows these costs only if such services are required for transportation and exceed the services necessary to place production into marketable condition required under §§ 206.152(i) and 206.153(i) of this part.

(g) *Nonallowable costs in determining transportation allowances.* Lessees may not include the following costs in determining the arm's-length transportation allowance under paragraph (a) of this section or the non-arm's-length transportation allowance under paragraph (b) of this section:

(1) *Fees or costs incurred for storage.* This includes storing production in a storage facility, whether on or off the lease, for more than 30 days;

(2) *Aggregator/marketer fees.* This includes fees you pay to another person (including your affiliates) to market your gas, including purchasing and reselling the gas, or finding or maintaining a market for the gas production;

(3) *Penalties you incur as shipper.* These penalties include, but are not limited to:

(i) *Over-delivery cash-out penalties.* This includes the difference between the price the pipeline pays you for over-delivered volumes outside the tolerances and the price you receive for over-delivered volumes within the tolerances;

(ii) *Scheduling penalties.* This includes penalties you incur for differences between daily volumes delivered into the pipeline and volumes scheduled or nominated at a receipt or delivery point;

(iii) *Imbalance penalties.* This includes penalties you incur (generally on a monthly basis) for differences between volumes delivered into the pipeline and volumes scheduled or nominated at a receipt or delivery point; and

(iv) *Operational penalties.* This includes fees you incur for violation of the pipeline's curtailment or operational orders issued to protect the operational integrity of the pipeline;

(4) *Intra-hub transfer fees.* These are fees you pay to hub operators for administrative services (e.g., title transfer tracking) necessary to account for the sale of gas within a hub; and

(5) *Other nonallowable costs.* Any cost you incur for services you are required to provide at no cost to the lessor.

(h) *Other transportation cost determinations.* Use this section when calculating transportation costs to establish value using a netback procedure or any other procedure that requires deduction of transportation costs.

[53 FR 1272, Jan. 15, 1988, as amended at 53 FR 45762, Nov. 14, 1988; 61 FR 5465, Feb. 12, 1996; 62 FR 65762, Dec. 16, 1997]

§ 206.158 Processing allowances—general.

(a) Where the value of gas is determined pursuant to § 206.153 of this subpart, a deduction shall be allowed for the reasonable actual costs of processing.

(b) Processing costs must be allocated among the gas plant products. A separate processing allowance must be determined for each gas plant product and processing plant relationship. Natural gas liquids (NGL's) shall be considered as one product.

(c)(1) Except as provided in paragraph (d)(2) of this section, the processing allowance shall not be applied against the value of the residue gas. Where there is no residue gas MMS may designate an appropriate gas plant product against which no allowance may be applied.

(2) Except as provided in paragraph (c)(3) of this section, the processing allowance deduction on the basis of an individual product shall not exceed 66% percent of the value of each gas plant product determined in accordance with § 206.153 of this subpart (such value to be reduced first for any transportation allowances related to postprocessing transportation authorized by § 206.156 of this subpart).

(3) Upon request of a lessee, MMS may approve a processing allowance in excess of the limitation prescribed by paragraph (c)(2) of this section. The lessee must demonstrate that the processing costs incurred in excess of the limitation prescribed in paragraph (c)(2) of this section were reasonable,

actual, and necessary. An application for exception (using Form MMS-4393, Request to Exceed Regulatory Allowance Limitation) shall contain all relevant and supporting documentation for MMS to make a determination. Under no circumstances shall the value for royalty purposes of any gas plant product be reduced to zero.

(d)(1) Except as provided in paragraph (d)(2) of this section, no processing cost deduction shall be allowed for the costs of placing lease products in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant. Where gas is processed for the removal of acid gases, commonly referred to as "sweetening," no processing cost deduction shall be allowed for such costs unless the acid gases removed are further processed into a gas plant product. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, MMS will not grant any processing allowance for processing lease production which is not royalty bearing.

(2)(i) If the lessee incurs extraordinary costs for processing gas production from a gas production operation, it may apply to MMS for an allowance for those costs which shall be in addition to any other processing allowance to which the lessee is entitled pursuant to this section. Such an allowance may be granted only if the lessee can demonstrate that the costs are, by reference to standard industry conditions and practice, extraordinary, unusual, or unconventional.

(ii) Prior MMS approval to continue an extraordinary processing cost allowance is not required. However, to retain the authority to deduct the allowance the lessee must report the deduction to MMS in a form and manner prescribed by MMS.

(e) If MMS determines that a lessee has improperly determined a processing allowance authorized by this subpart, then the lessee shall pay any additional royalties, plus interest determined in accordance with 30 CFR 218.54, or shall be entitled to a credit, without interest. If the lessee takes a deduction for processing on the Form