Natural Gas Prices and Royalty Value:
Different Concepts

Natural gas producers provide considerable information to their investors and governmental agencies about natural gas production, valuation and sales. They welcome transparency and increased understanding of the relationships between natural gas prices and federal royalties.

The value upon which federal royalties are paid monthly can be very different from the average price that companies report to the Securities and Exchange Commission (SEC) and their shareholders. The reasons are primarily because the laws governing shareholder disclosure are different from the laws governing federal royalties. The laws governing corporate reporting and disclosure are designed to protect investors, and the laws that govern federal royalty collections are designed to assure that taxpayers receive their share of revenues from minerals produced on federal lands as provided for by contract and statute. Producers work very hard to comply with the various legal requirements.

More specifically, perceived differences between prices reported to the public and in SEC filings and royalty value reported to the federal government can be caused by a number of factors:

- Prices reported by companies to their shareholders and the public (again, under strict regulation by the SEC) are contracted sales prices (including the effects of hedges, if any) without costs deducted as required by the SEC and accounting rules. These are sometimes referred to as “gross” or “realized” prices. Under current SEC rules and generally accepted accounting principles, costs (such as transportation to a market or sale point) are reported separately as “expense” items.

  Federal royalty value, on which royalty payments are calculated, is reported *after* deduction of certain allowable costs, so royalty value is often lower than reported sale prices. The sharing of costs through allowable cost deductions in calculating royalties has been the customary practice since the discovery of oil and gas in this country and is generally provided for in mineral leases and state and federal regulations for both private and public royalty owners. In addition, government-reported royalties often include adjustments from prior periods – sometimes several years’ worth – that can magnify differences even more.

- Prices reported by companies to their shareholders and the public are averages of those received for all production from state and private as well as federal lands. Depending on geographic location, federal production may sell at a price different than other production. For example, much production on federal lands in the Western United States typically trades at a discount to market center prices such as Henry Hub due to pipeline constraints, regional supply and demand and other factors.

  As a result, federal royalty values may differ from a company's overall average sale price for all of its production depending upon the location of the federal and non-federal production included in the average.

- Prices reported by companies to their shareholders and the public are for a corporate fiscal year (usually the calendar year) that is almost certain to differ from the federal government's fiscal year (October 1 – September 30) for which royalties are reported. There is a further 2-month reporting lag with respect to federal gas royalties to allow for data reporting, collection, and compilation by the government. For example, royalty values reported for calendar month October 2005 were generally derived from gas sales that occurred August 2005. There may be an even longer reporting lag for federal royalties paid pursuant to deep water royalty regulations, which provide for annual royalty payments on qualifying production.

  Federal royalty value differences from reported sale prices can, as a result, be significantly affected by what was happening in the market at different times – in some cases months.

- Prices reported by companies to their shareholders and the public are an average for all production volumes.

  Federal royalty value differences from reported sale prices can be magnified by the fact that *not* all federal volumes are included. Royalty incentive, or "suspension", volumes (such as to encourage deep or deep water natural gas production) are not included in the calculations.

Producers strongly support continuing increases in use of royalty-in-kind, which can serve to simplify the royalty relationship with the government, and to reduce costly and counterproductive litigation that can result from legitimate disagreements between government and private natural gas producers over complex royalty value calculations.

Finally, producers will continue to encourage more understanding of the evolving royalty system that has contributed to the most efficient and productive natural gas supply sector in the world.