Royalty Management Division

Industry Training 2023
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Royalty Management Division

Estevan Baca
Director
(505) 827-1218
ebaca@slo.state.nm.us

• Casandra Cano
  Deputy Director
  • (505) 827-5701
  • ccano@slo.state.nm.us

• Jeri Birge
  Compliance Manager
  • (505) 827-6634
  • jbirge@slo.state.nm.us

• Dilia Borunda
  Revenue Manager
  • (505) 827-5738
  • dborunda@slo.state.nm.us

• *VACANT*
  Audit Manager
  • royaltyaudit@slo.state.nm.us
Audit Bureau

Industry Training 2023
Audit Bureau Staff

*VACANT*
Audit Manager
royaltyaudit@slo.state.nm.us

- Jacqueline Montoya
  Royalty Auditor
  - (505) 827-5727
  - jdmontoya@slo.state.nm.us

- Deyanara Rivera
  Royalty Auditor
  - (505) 827-5740
  - drivera@slo.state.nm.us

- Kenda Montoya
  Royalty Auditor
  - (505) 827-5718
  - kmontoya@slo.state.nm.us

**AUDITOR**

Nutritional Facts
Serving Size: 1 Amazing Person

<table>
<thead>
<tr>
<th></th>
<th>% Daily Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Working</td>
<td>100%</td>
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<td>Passion</td>
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</tr>
<tr>
<td>Determination</td>
<td>100%</td>
</tr>
<tr>
<td>Caring</td>
<td>100%</td>
</tr>
<tr>
<td>Respect</td>
<td>100%</td>
</tr>
<tr>
<td>Caffeine</td>
<td>100%</td>
</tr>
<tr>
<td>Regret</td>
<td>0%</td>
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</table>

*These facts are 100% correct*
Agenda

• Goals of the Audit
• Scope Selection
• Types of Audits
• What to Expect During an Audit
• Audit Challenges
• Deductions
• Completion of an Audit
Goals of the Audit

• To ensure the Trust Beneficiaries get their fair share of royalties
  • 22 Beneficiaries comprised of the following:
    • Common Schools, Hospitals, Universities & Community Institutions

• Working together with industry to ensure that the royalties have been correctly remitted and allocated to the respective leases.
  • Each lease is linked to a specific beneficiary

• Compliance with Contract Terms (Lease/Cooperative Agreement)

• Customer Education/Support
Audit Selection

The Audit Bureau’s goal is to audit 80% of royalties in 4 to 5 year cycles

• Company Selection
  • Random Selection
    • Major focus is on the larger and midsize companies
    • Some selection of smaller companies
  • Business Relationships
    • Close Out
    • Mergers/Name Changes
    • Affiliations/Joint Ventures
• Other Field Audits & Referrals
  • When auditing an entity where there is shared interest property(s) and variances are identified
  • Interagency referrals, including required compliance review prior to refunds
Types of Audits

• **Desk Audit**
  • Smaller companies OR select properties identified through a prior audit of another company OR referral
  • Scope **not** large enough to warrant travel to the company

• **Field Audit**
  • Scope large enough to warrant travel to the company
  • Auditors on site for one or two weeks

• **Trespass Royalties**
  • Identified production without an active Unit/Comm agreement or Lease Contract
  • Royalties due on these schedules is 100% of value
  • Look out for Termination Notices on PUN(s) or Contracts
  • Upon filing a return a PUN error may result and remitted royalties will go into suspense
Pre-Audit

Both Field and Desk Audits begin with the following pre-audit procedures:

• Volume Review- Review volumes reported on the C-115 and Severance Tax returns to volumes reported on the OGR2, factoring in the State’s Net Interest (SNI)

• Value Review- Review of gross/net proceeds as well as per volume values reported to the NMSLO in comparison to the values reported to Taxation and Revenue

• Wellhead Price Review- A per volume value comparison to other remitters and other properties in same field or area

• Deduction Review- % of Gross Proceeds, comparison to other remitters and other properties in same field or area
Volume Comparison

- Volume Comparison Report

<table>
<thead>
<tr>
<th>SALE YEAR</th>
<th>SALE MONTH</th>
<th>PUN</th>
<th>PROP NAME</th>
<th>POOL IDN</th>
<th>C115 DISPOSITION</th>
<th>SNI VOLUME</th>
<th>ROYALTY VOLUME</th>
<th>ROYALTY DIFF</th>
<th>TAX VOLUME</th>
<th>TAX DIFF</th>
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<tr>
<td>2023</td>
<td>01</td>
<td>1234567</td>
<td>TRAINING</td>
<td>4567</td>
<td>1,000</td>
<td>100</td>
<td>1,000</td>
<td>500</td>
<td>1,000</td>
<td>0</td>
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</table>

OCD NMSLO AUDIT

<table>
<thead>
<tr>
<th>SALE YEAR</th>
<th>SALE MONTH</th>
<th>PUN</th>
<th>PROP NAME</th>
<th>POOL IDN</th>
<th>C115 DISPOSITION</th>
<th>SNI VOLUME</th>
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<th>ROYALTY DIFF</th>
<th>TAX VOLUME</th>
<th>TAX DIFF</th>
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</thead>
<tbody>
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<td>TRAINING</td>
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<td>500</td>
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<td>1,000</td>
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OCD NMSLO↑
### Example 1

**Volume Review**

<table>
<thead>
<tr>
<th>PUN</th>
<th>PROP NAME</th>
<th>MTHYR</th>
<th>VOLUME</th>
<th>SNI</th>
<th>ROYALTY</th>
<th>ROYALTY DIFF</th>
<th>TAX</th>
<th>TAX DIFF</th>
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<tbody>
<tr>
<td>1234567</td>
<td>TRAINING</td>
<td>Feb-21</td>
<td>1,000</td>
<td>675</td>
<td>325</td>
<td>1,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Value Review**

<table>
<thead>
<tr>
<th>PUN</th>
<th>PROP NAME</th>
<th>MTHYR</th>
<th>VOLUME</th>
<th>GRS VALUE</th>
<th>ROYALTY GRS PRICE</th>
<th>TAX GRS VALUE</th>
<th>TAX GRS PRICE</th>
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</thead>
<tbody>
<tr>
<td>1234567</td>
<td>TRAINING</td>
<td>Feb-21</td>
<td>675</td>
<td>$2,000</td>
<td>$2.96</td>
<td>$2,000</td>
<td>$2.00</td>
</tr>
</tbody>
</table>

- Volumetric discrepancy
- Price/MCF differs **but** gross proceeds match
  - No monetary audit finding
  - Underreported volumes
    - -0- MCF reported on product code 7
    - Amended reporting necessary

### Example 2

**Volume Review**

<table>
<thead>
<tr>
<th>PUN</th>
<th>PROP NAME</th>
<th>MTHYR</th>
<th>VOLUME</th>
<th>SNI</th>
<th>ROYALTY</th>
<th>ROYALTY DIFF</th>
<th>TAX</th>
<th>TAX DIFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1234567</td>
<td>TRAINING</td>
<td>Feb-21</td>
<td>1,000</td>
<td>675</td>
<td>325</td>
<td>1,000</td>
<td></td>
<td></td>
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</tbody>
</table>

**Value Review**

<table>
<thead>
<tr>
<th>PUN</th>
<th>PROP NAME</th>
<th>MTHYR</th>
<th>VOLUME</th>
<th>GRS VALUE</th>
<th>ROYALTY GRS PRICE</th>
<th>TAX GRS VALUE</th>
<th>TAX GRS PRICE</th>
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<tbody>
<tr>
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<td>TRAINING</td>
<td>Feb-21</td>
<td>675</td>
<td>$1,350</td>
<td>$2.00</td>
<td>$2,000</td>
<td>$2.00</td>
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</tbody>
</table>

- Volumetric discrepancy
- Price/MCF matches **but** gross proceeds differs
- Audit needed
Variances Review

• Common Causes:
  1) Underreported volumes due to -0- MCF reported on product code 7 line
  2) No reporting on Negative Gross Revenue
  3) No reporting on Negative Net Revenue
  4) No reporting on newly acquired properties
  5) Reporting on incorrect basis – Takes/Entitlements
  6) Reporting to incorrect:
     a) SNI
     b) PUN
     c) Product Code
     d) Allocation
     e) Pressure Base
What to Expect
Desk Audit - Overview

• The Auditor will:
  
  1) Inform the Company that they have been selected for a desk audit
  2) Provide draft schedules to the company for review
  3) Response is required on the draft schedules within 30 days
      a) Company agreement – Move on to “Next Steps”
      b) Company disagreement – Provide supporting documentation
  4) Final schedules will be provided

• Next Steps:
  
  1) The Company will file return(s) & remit payment
  2) Interest Assessment(s) will be generated
  3) Interest will be remitted
Typical Timeline of Field Audits

- **Pre-Audit** – Scope Selection
  - One to three weeks

- **Field Work**
  - One to two weeks
  - Dates will be coordinated

- **Post Audit**
  - Two to six weeks

Of course this is dependent upon the size of the scope, complexity of the properties, and other factors.
Field Audit - Initial Contact

• The Auditor will inform the Company that they have been selected for audit and develop a schedule of tentative field audit dates

• Engagement Letter
  • Objective of the audit
  • Number of auditors
  • Request for sample package
  • Confirmation of field audit dates
  • Company questionnaire
  • A list of necessary documents
Document Preparation

- Files uploaded to an FTP site or hardcopies
  - Each property should have a separate folder
  - Relevant documents should be placed in that respective property’s folder

At a **minimum** the following documents must be provided:

- ✓ Settlement Statements for all scoped properties and periods
- ✓ Allocation Schedules (if necessary)
- ✓ DOIs
- ✓ Contract Terms
- ✓ Cross-reference of wells and settlement statements (multiple statements and wells)
- ✓ Transportation and processing invoice statements
- ✓ Net back pricing and calculation methods

All documents used in your calculation of state royalties
Field Work

Discussion
• Opening conference
• Explanation of tests the auditors will perform
• Business practice questions
• Sample packet questions
• DOI walkthrough by the subject matter experts
• Company’s system walkthrough

Testing
• Volume, proceeds, deductions

Closing Conference
• Explanation of the tests the auditors performed
• Explanation of findings
• Questions/concerns
Post Audit

• Issue letter
  • Indicating the completion of the field work
  • Deadline for response (30 days)
  • Instruction on amendments

• Detailed Narrative Report
  • Company information
  • System Summary
  • Audit procedures performed
  • Conclusion

• Findings
  • Summary of Exceptions
  • Detailed audit schedules
Deductions

• Allowable
  • Post production costs to make the product merchantable

• Non-Allowable
  • New Mexico Gas Processors Tax (NMGPT)
  • Low Volume Fees, Throughput Fees or Low Margin Fees
  • Penalties
  • Marketing fees
  • Any other costs incurred not related to make the product merchantable
Completion of the Audit

• The audit is completed when all state royalties and interest due are paid
  • Remember when amending returns, previously booked lines must be backed out as they were originally filed, including the original transaction code
  • Audit filings need to be booked with a transaction code of 55

• The NMSLO does not close audits
  • Therefore, no closing letter will be sent at the end of the audit
  • Properties can be re-audited if changes are made to them
Audit Challenges

• Operator Changes/Acquisitions
  • Effective dates of royalty burdens

• Takes vs. Entitlements
  • Takes - Uniform Land Owner, Beneficiary & Royalty Rate
  • Entitlements – Everything else - Methodology is similar to federal royalty

• Reporting to Incorrect PUN – Production Unit Number
  • Volume comparison imbalances
  • Over/under payment of royalties
  • Affect distribution to Trust Beneficiaries
Audit Challenges

Reporting to the incorrect PUN(s)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>MONTH</th>
<th>PUN</th>
<th>PROPERTY NAME</th>
<th>POOL</th>
<th>C115</th>
<th>SNI VOLUME</th>
<th>REMITT VOLUME</th>
<th>DIFFERENCE</th>
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<tr>
<td>2020</td>
<td>2</td>
<td>1234567</td>
<td>TRAINING STATE</td>
<td>96830</td>
<td>94</td>
<td>100%</td>
<td>94</td>
<td>348</td>
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<tr>
<td>2020</td>
<td>2</td>
<td>7654321</td>
<td>TRAINING STATE COM</td>
<td>51300</td>
<td>254</td>
<td>100%</td>
<td>254</td>
<td>0</td>
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</table>

• Total volumes between the two properties is 348 BBLS
• All 348 BBLS are remitted to PUN 1234567
• No reporting to PUN 7654321
  • Will be an audit finding resulting in a lot of work for both agencies
  • May result in an underpayment of royalties if lease rates are different
  • May result in beneficiaries being under paid if lease royalty rates are different
Audit Challenges

Reporting:
Value & No Volume, Incorrect Pressure Base or Wrong Product Code

- Volume comparison imbalances
- NM standard pressure base on gas = 15.025
- Double check product codes
  - Common product codes

<table>
<thead>
<tr>
<th>Product Code</th>
<th>Type</th>
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<tbody>
<tr>
<td>1</td>
<td>Oil</td>
</tr>
<tr>
<td>2</td>
<td>Oil Condensate</td>
</tr>
<tr>
<td>4</td>
<td>Unprocessed Gas</td>
</tr>
<tr>
<td>3</td>
<td>Processed (Residue) Gas</td>
</tr>
<tr>
<td>7</td>
<td>Gas Plant Products</td>
</tr>
<tr>
<td>17</td>
<td>Carbon Dioxide Gas (CO2)</td>
</tr>
</tbody>
</table>
Audit Challenges

Statement volumes & values are referenced on the next slide.

Color coding: Wellhead Residue Liquids
Audit Challenges

- Product Code 7 reporting = Wellhead MCF – Residue MCF

<table>
<thead>
<tr>
<th>Line</th>
<th>PUN</th>
<th>Lease Number</th>
<th>Product Code</th>
<th>TXN Code</th>
<th>ARMS Length</th>
<th>Volume</th>
<th>NGL</th>
<th>BTU</th>
<th>Gross</th>
<th>Transportation Deduction</th>
<th>Marketing Prep/Other</th>
<th>Processing Deductions</th>
<th>Gas</th>
<th>STATE ROYALTY</th>
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<tr>
<td>1</td>
<td>1234567</td>
<td>V0-123</td>
<td>3</td>
<td>51</td>
<td>Y</td>
<td>1268</td>
<td></td>
<td>1277</td>
<td>1718</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>286</td>
</tr>
<tr>
<td>2</td>
<td>1234567</td>
<td>V0-123</td>
<td>7</td>
<td>51</td>
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<td>10114</td>
<td>4672</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>779</td>
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</tbody>
</table>

- Wellhead MCF was 1,893 \((1,931.25 \times (14.73/15.025))\)
- Residue was 1,268 \((1,293.22 \times (14.73/15.025))\)
- Product Code 7 MCF Reporting 1,893 – 1,268 = 625

Volume & values above are referenced from the previous slide
Color coding: Wellhead Residue Liquids
Audit Challenges

• Unit Accounting
  • P/A Wells or N/P Wells
  • Phases
  • Unit/Com Wells aka Overlap Wells
  • Consent/Non-consent Wells
  • DOI Information

• CDPs
  • Settlement Statements
  • Incorrect Allocations

• Netback Pricing
  • Supply pools
  • Weighted Average Sales Price (WASP) calculations

• Affiliated Sales
  • Tracing – First Arm’s length Sale
Contact Us

In an effort to improve our process we invite you to contact us with suggestions you would like to make regarding our filing process or applications.

We look forward to hearing from you!
New Mexico State Land Office

QUESTIONS???
Audit Bureau

Thank you for your time and participation!