

WEXPRO COMPANY

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G. L. NORDLOH

July 11, 1989

CONFIDENTIAL

Gary J. Myers
Price Waterhouse
175 East 400 South
Suite 700
Salt Lake City, UT 84111

Dear Mr. Myers:

Re: Wexpro Agreement - Federal Royalty Assessment of
Brady Liquids -- Adjustment to Manufacturing
Allowance.

This letter summarizes our discussions pertaining to the above matter and the guidelines reached as to the treatment under the Wexpro Stipulation and Agreement of this contingent liability on royalties and taxes for Brady liquids.

FACTS:

As discussed in our meeting, the Brady Gas Plant contracts provide that the plant owners (Mountain Fuel Supply Company "MFS", Champlin, now known as Union Pacific Resources "UPRC", and Amoco) shall receive a processing fee of 2/3rds of the liquids processed or the proceeds therefrom. MFS, UPRC, Amoco and Exxon are customers of the Plant. UPRC is the "Operator" of the Plant and has paid royalties and taxes on all production from the Brady Unit for and in behalf of MFS and Wexpro Company. In doing so, UPRC has consistently taken a 2/3rds manufacturing allowance against the value of liquids produced.

A manufacturing allowance (also known as a processing fee or allowance) is a deduction from the value of production to offset the cost of extracting liquids from a wet gas stream and the cost of fractionating the liquid stream into constituent products.

Pursuant to federal regulations and policy, the federal government typically did not charge royalties against the value of production retained by plant owners as a processing fee. Thus, a 2/3rds manufacturing allowance became a common practice since the 1920's in calculating and paying federal

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royalties on liquids extracted from wet gas 1/, except when an arms-length contract did not exist between the plant owners and the producers. Because there was uncertainty with the regulations in general and because there was no arms-length contract for UPRC's or MFS's production, UPRC requested approval from the United States Geological Survey (now Minerals Management Service "MMS") for a 2/3rds manufacturing allowance.

Nevertheless, in performing an audit of UPRC for the years 1980 through 1986, MMS determined that no approval for manufacturing allowance was ever granted. MMS has made demand on UPRC to redetermine the manufacturing allowance based upon a "net realization formula" which limits the allowance to actual costs not to exceed 2/3rds. UPRC has appealed the decision of MMS and notified Wexpro Company and MFS that they are responsible for approximately 95% of the royalty claim being made by MMS because they own most of the federal production going through the plant. 2/ In response, Wexpro has notified UPRC that any obligation should be shared by the plant owners based on plant ownership.

Wexpro is presently assisting UPRC in challenging the MMS determination as well as making its own independent investigation concerning potential exposure if royalties are recalculated based on the net realization formula. While the issues are still being litigated elsewhere in the U.S. and the results are uncertain, Wexpro's preliminary research indicates that UPRC could be unsuccessful in proving that MMS approved a 2/3rds manufacturing allowance for the Brady Gas Plant. Moreover, Wexpro's investigation indicates that under the net realization formula, Wexpro and MFS have a combined potential federal exposure at July 1989 of \$3.077 million dollars, including principal and interest.

Key points of dispute under the net realization formula include overhead charges, rate of return, and limitations on certain costs. Wexpro estimates that at least half of the liability consists of interest. Since 1980 the interest rate has greatly fluctuated going as high as 15.5%. MMS reports that the present rate is approximately 11% compounded daily. In the absence of settlement, outside counsel for UPRC and Wexpro predicts that administrative and court proceedings could take between five to ten years. As we discussed, MMS will allow a contestant to pay the amount claimed under protest (which would stop the interest penalty it would later pay if unsuccessful); however, if the contestant is successful, the MMS will merely return the principal amount without interest.

Not included in the estimation of potential liability is the exposure that may exist should the state of Wyoming similarly challenge the payment of royalties for production attributable to the state lease in the Brady Unit. Also, there may be exposure for additional ad valorem and production taxes depending on the methodology used by UPRC in paying taxes with respect to Brady liquids.

PROBLEM:

Should UPRC be unsuccessful in its appeal to the MMS and should Wexpro (for itself and/or MFS) be liable for payment to the MMS, how should those payments (including pre July 31, 1981 payments of principal) be accounted for under the Wexpro Agreement? Should Wexpro for tactical reasons make full or partial payment or apply pending royalty offsets before all appeals are concluded, how should the payments, when made, be handled and any later refunds, if any, be accounted for by Wexpro?

GUIDELINE:

In our meeting, we discussed several alternatives of treating this contingent liability under the Wexpro Stipulation and Agreement for accounting purposes. It was agreed that the following procedures will be followed:

1. Wexpro's payments for all "additional costs" resulting from the MMS and/or Wyoming (including Sweetwater County) audits on the Brady Plant will be shared 54% to MFS and 46% to Wexpro. Costs will be recognized at the time they are incurred.

2. The following items will likely generate "additional costs."

- a. Federal royalties (\$750,000 to \$1.5 million)
- b. Federal interest on royalties (\$800,000 to \$1.6 million)
- c. State royalties (\$50,000 to \$100,000)
- d. State interest on royalties (\$50,000 to \$100,000)
- e. State production and ad valorem taxes (\$0-\$1.5 million) 3/
- f. State interest on taxes (\$0-\$1.5 million)
- g. Attorney fees and costs for appeals (\$50,000)

3. MFS will be billed directly for its 54% share of additional costs.

4. Any reduction or refunds of additional costs obtained through appeal, negotiation, settlement, offsets, etc. will be shared 54% to MFS and 46% to Wexpro. Royalty offsets associated with MFS cost of service gas will be applied only against the MFS share of additional costs.

5. Any refunds or payments associated with pre July 1981 audit periods will also be shared 54% by MFS and 46% by Wexpro.

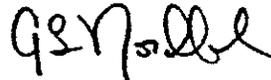
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We believe the above proposed accounting treatment for the Brady liquids royalty and tax claims is reasonable and in accordance with the Wexpro Agreement. We respectfully request your early concurrence.

Very truly yours,

APPROVED
PRICE WATERHOUSE

By: James W. Campbell 8-3-89
Date



G. L. Nordloh
Executive Vice President
Chief Operating Officer

APPROVED
UTAH DIVISION OF PUBLIC UTILITIES

By: Frank [unclear] Oct 24, 89
Date

APPROVED
STAFF OF THE WYOMING PUBLIC SERVICE
COMMISSION

By: Stephen G. O'Leary 11-7-89
Date

1/ "The regulations in place during this period imposed a dual system for determination of the processing allowance, and did not patently distinguish extraction from fractionation. The old regulations determined the value basis for computing royalties on gas produced onshore on the basis of . . . the value of 1/3 (or the lessee's portion if greater than 1/3) of all casinghead or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture and no royalty thereon is required." [Citing 30 CFR § 206.106 (1986)].

. . .

"These regulations provided little guidance to the lessee as to the proper manner of calculating the processing allowance and it was left to the MMS to develop policies, procedures and internal guidelines to develop formulas to implement the processing allowance. . . ."

See, "Accounting Concepts Applicable to Federal Royalty Analysis of the Processing Allowance Formula," Royalty Valuation and Management, Paper No. 2a, Page No. 2a-3 (Rocky Mt. Min. L. Fdn. 1988).

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- 2/ When UPRC appealed the MMS determination, MMS requested that UPRC post a \$5.2 million dollar bond. UPRC informed MMS that based on its investigation of the matter and using MMS's criteria, the bond amount should be no more than \$2.5 million. MMS has temporarily allowed UPRC to post a \$2.5 million bond or letter of credit and has requested that UPRC justify the \$2.5 million dollar figure.

- 3/ It is Wexpro's current opinion that the chances are minimal that additional production taxes will be levied by the state.