Dow L. Campbell
Attorney

Marathon Oil Company

539 South Main Street
Findlay, OH 45840-3295
Direct No. 419/421-4121
Main No. 419/422-2121
FAX 419/421-2854

August 1, 1997

Via Overnight

Mr. David S. Guzy, Chief
Rules & Publications Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil Supplementary Proposed Rule (62 FR 36030, July 3, 1997)

Dear Mr. Guzy:

Marathon Oil Company ("Marathon") appreciates the opportunity to comment on the supplementary proposal on establishing oil value for royalty due on federal leases.

Marathon commends the Minerals Management Service ("MMS") for considering modifications to its original proposal. However, Marathon is deeply disappointed at MMS' failure in its supplementary proposal to address the numerous comments submitted by the states, industry organizations, and oil and gas companies on most of the issues raised by MMS' January 24, 1997, Notice of Proposed Rulemaking ("NOPR"). Input from these diverse and knowledgeable sources is critical to the success of any rulemaking proposal, especially one as significant as the valuation of crude oil.

With this in mind, Marathon offers the following comments and suggestions regarding MMS' proposals:

Concerns with the Original MMS Proposal

As noted in Marathon's May 27, 1997, comments, the NOPR has many fundamental problems associated with it that MMS has failed to address in the supplemental proposal. In addition to the concerns raised in our May 27, 1997 comments, Marathon also notes the following with respect to the NOPR:

<u>Duty to Market</u>:

MMS' assertions respecting a lessee's alleged duty to market are of fundamental concern to Marathon, yet MMS has not addressed any of the comments submitted on this issue. MMS' attempt to create by regulation an obligation of the lessee to market production at points remote from the lease, but at no cost to the lessor, is an unjustified departure from current law. Marathon believes that an attempt to impose such an obligation is well beyond the statutory authority of MMS.

Index-Based Valuation:

Marathon objects to any MMS proposal which fails to value production on the market value at the lease. However, if MMS imposes an index-based netback-calculated value, it must address the quality/gravity adjustments and the prompt month calculation.

There are actual quality differences between the individual lease production and the common stream with which the production is commingled. Some pipeline systems administer gravity banks and quality banks to ensure that shippers are not adversely affected by the commingling process. When production is subject to a gravity bank or quality bank, the actual debits and credits should be used. When there is no gravity bank or quality bank, gravity adjustments should be made in accordance with typical arm's-length practices in the area. Marathon's review of the NOPR has identified the following as specific examples where quality adjustments are necessary: Wyoming Asphaltic crude ranges from 16 degrees API to 27 degrees API; Outer Continental Shelf crude ranges from 20 to 45 degrees API, and from 0.5 to 3.5 percent sulfur; and West Texas Sour crude ranges from 26 to 37 degrees API. As evidenced by these significant ranges of gravity and quality, appropriate adjustments must be made to any netback-calculated value in order to more accurately replicate actual lease transactions, and, thus, more closely represent actual value at the lease.

The prompt month calculation of the NYMEX/index-based methodology is flawed. If MMS is truly interested in contemporaneous pricing in its methodology, then MMS must switch to a calendar month average for NYMEX, which would be an average of the prompt NYMEX settle price for each day of a production month.

Concerns with the Supplemental MMS Proposal

The supplemental MMS proposal (62 FR 36060, July 3, 1997) also has problems associated with it that MMS must address. Among them are:

Arm's-Length Exchange Agreement Election:

Clarification is needed from MMS on the election referenced in Paragraph 206.102(a)(6)(i) regarding the choice for valuation methodology for arm's-length exchange agreements. Will this be a one-time "election" by the lessee? If not, at what periodic intervals will subsequent "elections" be permitted? If factual circumstances change, will the lessee be permitted to freely change its "election"? If not, what restrictions/requirements will MMS have?

Definition of the Term "Overall Balance":

MMS' supplementary proposal references the term "overall balance", yet fails to define it. As Marathon understands the term, Marathon does not maintain an overall balance with any company. However, without an MMS definition, there is ample room for confusion over and/or misunderstanding of this terminology. Marathon does not object to notifying MMS that no such balances are being maintained with other lessees, provided MMS clearly defines the term before requiring notification.

Crude Oil Calls:

Crude oil calls at market price are legitimate business transactions, and nothing should be suspect about the price. The transfer of a call provision is also a legitimate business transaction and should not be suspect as long as the call is at market price.

Oil Valuation Alternatives

MMS continues to request alternatives for valuing production. Specifically, MMS has requested comments on alternatives for valuing production not sold under arm's-length contracts (62 FR 36032). Marathon supports both a benchmark system based on comparable arm's-length transactions in the field or area and a royalty-in-kind program.

Although MMS contends that there is no market at the lease, in reality, independent and integrated refiners compete rather aggressively for lease crude oil for refinery supply; similarly, resellers compete for lease crude in order to utilize transportation assets effectively and efficiently. Arm's-length transactions at the lease cannot be ignored. Prices established under arm's-length sales and/or arm's-length purchases of comparable crude in the field or area should be used to value crude oil disposed of under non-arm's-length transactions for royalty purposes. If a significant quantity of the crude oil in a field or area is not sold pursuant to arm's-length agreements, the lessee would use an acceptable netback methodology for royalty purposes. However, any netback methodology should be the exception to the rule rather than the rule itself. Marathon fully endorses the benchmark system outlined in the comments to the Supplementary Proposed Rule submitted by the Independent Petroleum Association of America ("IPAA").

Also, Marathon urges MMS to work with lessees to develop and implement a comprehensive, workable royalty-in-kind program. Marathon is taking an active interest in this issue as evidenced by Marathon's written statement in support of our testimony before the U.S. House of Representatives Subcommittee on Energy and Mineral Resources attached hereto as Exhibit "A".

Conclusion

In accordance with lease terms and MMS' long history of valuing production at or near the lease, Marathon strongly objects to the proposed rule which attempts to value crude oil at the lease using a futures price applicable to a market several hundred miles from the point of production. Marathon again urges MMS to withdraw the proposed rule.

If you have any questions please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention Desk Officer for the Department of the Interior
725 17th Street, N.W.
Washington, D.C. 20503

[81067]

Exhibit "A"

WRITTEN STATEMENT BY

FRED D. HAGEMEYER
COORDINATING MANAGER - ROYALTY AFFAIRS

MARATHON OIL COMPANY

BEFORE THE

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
U.S. HOUSE OF REPRESENTATIVES

JULY 31, 1997

Madam Chairman and Members of the Committee:

I am Fred Hagemeyer, and I am pleased to be here this afternoon representing Marathon Oil Company, a wholly-owned subsidiary of USX Corporation. Marathon is a fully integrated oil company with 1996 revenues of $16.3 billion. The company is involved in worldwide exploration, production, transportation, and marketing of crude oil and natural gas, and domestic refining, marketing, and transportation of petroleum products. Marathon's 1996 domestic production from 20 states was 122,000 barrels per day of crude oil and natural gas liquids, and 676 million cubic feet per day of natural gas. Marathon has the nation's eighth largest refining capacity with refineries in Garyville, Louisiana; Texas City, Texas; Robinson, Illinois; and Detroit, Michigan. These refineries ran a total of 511,000 barrels per day in 1996. Marathon is involved in wholesale and retail marketing of refined products. In 1996, the company had refined product sales of 704,000 barrels per day, which included 412,000 barrels per day of gasoline.

Marathon holds many federal and Indian leases both onshore and offshore. In the federal OCS 166 Lease Sale in March, Marathon and its bidding partners were awarded 11 blocks in 9 prospects in the Gulf of Mexico. These prospects increased Marathon's inventory of Gulf prospects to 50. In 1996, Marathon paid royalties of over $84 million for oil and natural gas produced from federal and Indian lands. In addition to the royalty paid in-cash, the Minerals Management Service (the "MMS") took crude oil valued at over $9 million in-kind through the small refiner royalty-in-kind program. The royalty-in-kind volumes were taken primarily from OCS leases and onshore leases in Wyoming and Colorado.

We are here today to discuss royalty-in-kind ("RIK") as an alternative method for satisfying the royalty obligations of producers with federal oil and gas leases. Royalty-in-kind is certainly not a new topic. The MMS has always had the option of taking its royalty in-kind as opposed to in-value. By fully exercising this option and marketing its royalty production, the MMS would eliminate valuation disputes with its lessees. Industry's interest in a comprehensive royalty-in-kind program and the certainty it would provide to federal lessees was demonstrated earlier this year. The public workshops held by the MMS this spring in Casper, Wyoming; Houston, Texas; New Orleans, Louisiana; and Farmington, New Mexico to discuss and review possible options for a major royalty-in-kind program were widely attended by all segments of the oil and gas industry. Marathon actively participated in these sessions and welcomed the opportunity to candidly discuss critical features of a workable RIK program. Royalty-in-kind was also a recurring theme in the testimony offered at the April 15 and 17, 1997 MMS public hearings on the January 24, 1997 Proposed Rulemaking on Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil. In published comments to the proposed federal rulemaking, royalty-in-kind was suggested, in some form, by almost all of the major oil and gas trade associations as an alternative to the proposed rulemaking. Royalty-in-kind is also supported by at least one of the consultants used by the MMS to develop the proposed oil valuation regulations. In a February 21, 1995 report to the State Lands Offices of Colorado, New Mexico, and Texas, Summit Resource Management, Inc. said, "The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in-kind for sale by the state agency."

Marathon applauds the MMS' decision earlier this year to conduct an in-depth reengineering of all core processes of the Royalty Management Program. Marathon, and the oil industry in general, has developed a great deal of expertise over the last ten years in reengineering business processes. Reengineering is the term used to describe fundamental changes to a process. It is not just rearranging steps, but rather evaluating each step, eliminating those which are not value added, and adding new steps, if necessary. At Marathon, we have learned that reengineering an entrenched process is not easy, but if all stakeholders are engaged in the process and it is done properly, the results can be significant. Many times the benefits are much greater than anticipated, because it is difficult to identify all the indirect benefits. As part of the MMS' reengineering effort, Marathon believes a RIK program can be created which will fundamentally add value to the MMS' royalty process. Royalty-in-kind is a concept whose time has come. The key is turning this opportunity into reality.

As discussed at the royalty-in-kind workshops, a comprehensive in-kind program need not be complicated. If the MMS were to take its royalty oil or gas in-kind at or near the point of production, the MMS would control the valuation of its share of the production, and a federal lessee would only be required to report production volumes. The MMS could take its royalty barrels at the point established by the Bureau of Land Management onshore, or the MMS offshore, for the measurement of volumes for royalty purposes. The MMS could then contract with a number of companies with marketing experience to act as the MMS' agents to aggregate and market the royalty oil or gas for optimal value.

By taking its royalty oil or gas in-kind, the MMS would experience three key benefits. First, the MMS would have the opportunity to optimize the value of its royalty oil and gas in the marketplace. Second, a royalty-in-kind program would alleviate the complexities and uncertainties of determining market value at the lease. When its royalty is taken in-kind, the market value is simply the price the MMS receives from a willing buyer. And third, the administrative burdens of both the MMS and the federal lessees, especially audit and litigation costs, would be reduced significantly or even eliminated.

A review of the current royalty payment process shows it is fraught with redundant steps and disputes over valuation. This process begins with the reporting of production volumes to the MMS. Another report is submitted to the MMS showing the volumes and values being paid by the lessee. The MMS then compares these reports and begins a cycle of checking and auditing the reports and payments. It is during this process that disputes between the MMS and the lessee arise. Although many disagreements over royalty payments are successfully resolved, they consume the time and resources of both the MMS and industry. Almost all of the lengthy disputes and lawsuits are over valuation issues; very few concern volume discrepancies.

If the MMS would take its royalty share of production in-kind, at or near the wellhead, the valuation review and audit cycle would virtually be eliminated. By selling its royalty share of production, the MMS would be assured of a price it agrees to for a particular lease. A streamlined process could be created where only a volume report would be sent to the MMS. Certainly, the MMS would have to verify the volumes, but that is a rather straightforward process. The administrative savings achieved by reducing the audit function and the expense of litigation would be one avenue of revenue enhancement.

The second channel of revenue enhancement is the MMS' opportunity to aggregate volumes, determine the most favorable sales locations, arrange transportation, and negotiate the terms and conditions of the sale of its royalty production. Participation in these activities can result in optimized value if the MMS is willing to manage the risks and incur the costs associated with the marketing function. Expertise of a competitive private marketer would allow the MMS to participate in the described activities in the most efficient manner possible and thus achieve the greatest possible revenue benefits.

During the last several weeks, a multi-association task force has been formed to develop a workable federal royalty-in-kind program. This group is comprised of representatives from over a dozen oil and gas trade associations, including the American Petroleum Institute ("API"), Independent Petroleum Association of America ("IPAA"), Rocky Mountain Oil & Gas Association ("RMOGA"), Domestic Petroleum Council ("DPC"), Independent Petroleum Association of Mountain States ("IPAMS") and Mid-Continent Oil & Gas Association ("MOGA"). Marathon is an active participant in this task force through its membership in API. The efforts of this task force are important to Marathon for two reasons. First, Marathon would welcome the certainty of knowing its royalty obligation was fulfilled once the royalty barrels were delivered to the MMS. And second, Marathon recognizes that expertise in all segments of the oil and gas business will be necessary to develop a federal royalty-in-kind program that is viable and workable. The multi-association task force is a means to effectively utilize the expertise and resources of a wide variety of oil and gas companies in developing a federal RIK program.

Marathon believes this multi-association task force offers a great opportunity to develop a meaningful, well conceived RIK program which addresses the major concerns of all stakeholders. Essentially, this task force is embarking on a major reengineering initiative which is not inconsistent with the general reengineering goals of the MMS. It seems that the Subcommittee on Energy and Mineral Resources can benefit tremendously from the efforts of this task force. This process is not easy, but we feel it is vitally important in developing a successful RIK program.

The mission of the task force is "To design a federal royalty-in-kind ("RIK") program that will eliminate valuation uncertainty and that will be attractive to federal, state and private sector stakeholders while recognizing the differences between oil and gas production." To accomplish this purpose, the task force identified six principles which a royalty-in-kind program should encompass.

First, the program should reduce administrative and compliance burdens while providing the opportunity for federal and state governments to maximize revenues. The MMS and states should have the ability to optimize value by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. The potential for increased revenues will require the MMS to manage the risks and costs associated with marketing royalty oil and gas. Federal leases should not realize an increase in administrative costs or experience operational burdens, but have certainty through elimination of disputes associated with royalty valuation. Similar benefits will also accrue to the government. An effective RIK program should not impose upon lessees any costs or obligations beyond the lessee's obligation to deliver at or near the lease. Reporting should be related to volumes produced and delivered, not sales prices or other related valuation information. Also, marketers should be provided a business opportunity which has an acceptable risk/revenue ratio thereby enticing participation by the most professional and successful marketers in the business.

The second principle requires transactions at or near the lease that fulfill the lease obligations. RIK production must be delivered at or near the lease. The government must give sufficient notice and take for a certain minimum period of time. Once delivered at an RIK delivery point at or near the lease, the lessee's royalty obligation must be completely satisfied. A lessee has no duty to market or transport the government's oil or gas past this point. All risks and costs incurred downstream of the RIK delivery point should be borne by the lessor or its purchaser, in the hope of realizing maximum revenue from reselling the production downstream.

The purchaser who takes delivery at the RIK delivery point is actually taking from the government and performing under a separate contract. The lessee and the government's purchaser have no contractual relationship with each other. An effective RIK program should not hold the lessee liable for the purchaser's failure to perform under the RIK contract, nor should it hold the purchaser liable for the lessee's failure to perform under the lease contract.

The third principle provides that when the government elects to take in-kind it must take all royalty production for a time certain. If the government takes its royalty in-kind, it must give sufficient notice and for a time certain take the full royalty fraction tendered by the lessee(s) from a given property. The government has no right under the lease to defer its take obligation or leave its production in the ground. The government has no right under the lease to defer any production from either new or existing leases. Otherwise, lessees will be unfairly burdened by having additional marketing and operational problems with which to contend.

The fourth principle requires use of private marketing expertise to streamline government operations. The government's oil or gas should be marketed through a competitive, privatized system in order to maximize benefits and streamline government operations.

The fifth principle provides for states to have the opportunity to be involved in designing and implementing the program. At least one state, Wyoming, has been actively promoting the RIK concept this year. In addition to being actively involved in the design of a government RIK program, the states need to be given the opportunity to participate in the marketing of federal royalty stream taken in-kind. Any program should follow these principles.

Finally, the sixth principle makes royalty taken in-kind broadly available for public purchase. The purchase of hydrocarbons subject to this RIK program should be made available on an open competition basis to a broad-based public market. This should include providing the opportunity to market to a broad group of interested and qualified marketers.

An important step in designing a royalty-in-kind program is to look at an example of an existing RIK program. In November 1988, the General Land Office ("GLO") in Texas initiated a royalty-in kind program for oil, followed by The University of Texas System ("University") in 1990. Since 1988, the GLO has taken all of its royalty oil in-kind from the Marathon-operated Yates Field, one of the largest onshore oil fields in the United States. The Yates crude oil is gathered and transported from the lease to a central battery unit where custody transfer takes place. Currently, the GLO is taking over 2,000 barrels per day in-kind. Marathon also has experience with the University's RIK program as operator of the Big Lake Field.

Overall, Marathon's experience, with both Texas royalty-in-kind programs has been positive. The programs provide certainty for the in-kind barrels by satisfying Marathon's obligation to the lessor and eliminating protracted disputes over valuation issues for both Marathon and the lessors. Marathon firmly believes greater benefits could be recognized by both the state and Marathon if these royalty-in-kind programs were expanded. Furthermore, as an operator of four refineries and a net purchaser of crude oil, Marathon welcomes the opportunity to bid on the royalty barrels offered by the GLO and University.

One of the lessons learned from the Texas RIK programs is that any new comprehensive program is going to experience start-up problems. During the first year of the Texas programs, there were problems concerning which party was responsible for gathering costs, the arrangement and verification of transportation, and the proper allocation of production. For example, there was a dispute between the first purchaser of the GLO's Yates crude and Marathon regarding the delivery point of the oil and the 12½ cents per barrel gathering fee. The purchaser eventually paid the gathering tariff, but not until Marathon, as operator, expended a great amount of time and effort on the matter. Marathon would be remiss if it failed to acknowledge that this testimony might be much different if it were given in 1990. However, over time producers, purchasers, and the state have been able to work through these operational, transportation, marketing, administrative, and communication issues.

While not without imperfections, the royalty-in-kind programs in Texas are very workable, viable alternatives to royalty paid in-value, and Marathon believes a wide-scale royalty-in-kind program is also workable for federal lands. It is imperative to understand that adequate time must be allowed to overcome the initial hurdles of a royalty-in-kind program. There is no way to totally eliminate the learning curve. The MMS must recognize that the early stages of an RIK program or even a short duration pilot program can, and most likely will, provide misleading results. Only after the program has been in place for an extended period will meaningful results be obtainable. For this reason, the MMS must be very careful if it chooses to implement and evaluate any royalty-in-kind pilot program. In fact, Marathon believes it would be more prudent to expend the effort to develop a permanent royalty-in-kind program that could be phased in over time.

Madam Chairman, in your letter inviting me to testify in today's hearing, you asked that I comment on how a national program could increase revenue to the federal and state treasuries. A properly developed RIK program provides the federal government with the opportunity to not only achieve revenue neutrality, but also to increase net revenue. Both the MMS and industry generally agree that value can be added downstream of the lease by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. In addition, a comprehensive RIK program will allow significant cost savings to the federal and state governments. However, Marathon realizes legislation may be needed to ensure that a comprehensive RIK program satisfies the requirements of the federal and state government as well as federal lessees.

Marathon is concerned that the impact of a royalty-in-kind program on the federal and state treasuries be analyzed properly. When the MMS decides to "check" on its progress, it must add cost savings from reduced overhead to revenue enhancement in order to determine the degree to which the program is a success. As illustrated by Marathon's experience with the RIK programs in Texas, any review or analysis during the first year can provide misleading information. Marathon believes this is the case with the MMS' review of the 1995 Royalty Gas Marketing Pilot Program. The MMS' analysis of this program concluded that royalties collected during the pilot were less than would have been collected if the MMS continued to collect the royalties in-value. However, like the Texas experience, Marathon believes the real benefits of a comprehensive federal RIK program can only be realized after sufficient opportunity to work through the initial problems. Unfortunately, the MMS' gas RIK pilot program did not allow sufficient time to work through the difficulties encountered. Moreover, the results of the gas RIK pilot program were far from dismal.

As previously indicated, Marathon participates in a number of industry associations, including API, which are concerned with royalty valuation issues. API recently completed an assessment of the MMS' review of its 1995 Royalty Gas Marketing Pilot Program conducted in 1995. The key points of API's study of the pilot program are:

- With such a limited test, it is statistically inappropriate to estimate revenue neutrality as a single number rather than as a range of possible values. If proper adjustments were made for uncertainty, the MMS could have found the pilot study was well within the expected range of revenue neutrality.

- As a result of the lessons learned from the pilot program by industry and the MMS, program modifications will enhance revenues in an expanded and permanent program. These lessons learned include those related to transportation arrangements, the packaging of gas taken in-kind into larger volumes, and further administrative cost savings.

- Finally, a more careful analysis of the longer run consequences of a well-designed program will likely find that revenues would be greater than what was estimated by the MMS. Proper recognition of the economic incentives resulting from risk reduction and administrative savings will encourage operators to extend the effective life of fields (thereby prolonging the stream of royalty payments) and increase lease bonus payments on new leases. These impacts were not accounted for by the MMS in its evaluation of the pilot program.

Attached to this testimony is the report prepared by the American Petroleum Institute. The concerns raised by the API must be addressed before any final conclusions are drawn regarding the budgetary impact of the gas royalty-in-kind pilot program. Furthermore, because neither API's approach nor that used by the MMS strictly follows congressional budget score-keeping procedures, another study has been initiated which will, in a more formal way, address the revenue effects of the pilot program using the required congressional budget scoring rules. This study will be available in the near future.

In summary, Marathon believes the time has come for the federal government and the oil and gas industry to seriously consider royalty-in-kind as the best long-term solution to satisfying the federal lessees' royalty obligation. A properly developed RIK program could streamline the royalty process for the federal and state governments and the oil and gas industry.

Marathon's participation in the multi-association task force is a clear indication that the company is committed to helping develop an RIK program that will satisfy the major concerns of all stakeholders. Marathon, along with many other federal lessees, is committed to working with this Committee and the MMS to develop a workable royalty-in-kind program. Working together we can minimize many of the start-up problems which may occur and shorten the learning curve for both the federal government and the lessees. A royalty in-kind program can be a win/win proposition for all parties involved.

79513.01