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November 5, 1997

David S. Guzy
Rules and Procedure Office
Royalty Management Program
Minerals Management Service
Denver Federal Center, Bldg. 85
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Re: **Response to MMS Notice of September 22, 1997**

Dear Mr. Guzy:

I. General Comments

In its notice of September 22, 1997 the MMS requested comments on five alternatives related to the valuation of crude oil produced on federal leases. Since that time, the MMS has held several "workshops" where participants have discussed the proposed rule and various alternatives. California representatives at those workshops made its views clear regarding the proposed rule and the alternatives raised in the September 22, 1997 notice. We strongly support the original rule as it applies to California, that is to base royalty value on the spot price of Alaskan North Slope crude oil. ANS is the only crude oil traded in large volumes in true arm's-length transactions in California and thus is the best indicator of the market value of crude oil in this area. We believe that this is the most effective and efficient method for computing royalty values for California crude oils, and as the findings of the Interagency Task Force demonstrated, clearly reflects that manner in which the oil companies themselves valued California crude oil. In this response we will describe why the alternatives raised in the September 22, 1997 notice cannot be applied to California crude oil. Furthermore, if the MMS finds it necessary to keep the rulemaking process for crude oil produced east of the Rockies open, we strongly urge the MMS to separate the rulemaking process for California oil and publish a final rule utilizing this methodology as soon as possible.

II. Alternatives

Alternative 1: Tendering Program. The first alternative is the "bid-out" or Tendering Program. This type of program is not feasible in California, and not surprisingly no company is presently engaged in such a program in California. A Tendering Program is not feasible in California for many of the same reasons that the gross proceeds methodology has failed to attain prices reflecting market value. The California market is not competitive due to the declining number of producers and a limited number of purchasers of crude oil. Moreover, the pipeline transportation system in California is still restricted because the heated pipelines necessary to move heavy crudes are privately owned. There is no evidence that such a program would achieve market value prices.

There is no evidence that Conoco, a proponent of the Tendering Program methodology, has achieved market value prices East of the Rockies. Conoco's tendering program is new and is effectively untested. There is insufficient evidence to support its claim that its program has achieved market value for its crudes. First, for any bid-out program to achieve market value, it is necessary that a significant volume of the company's production be put out to bid. By Conoco's own admission, Conoco currently puts out approximately 10% of its volume in a given pricing district. This is not nearly enough to be representative of the market. A minimum of 30% of the company's production in the given area would have to be put out for bid to make it a realistic gauge of the market. Any lesser percentage would facilitate "game playing".

Second, the number of bids and bidders who chose to submit bids to Conoco are clearly insufficient to establish the market value of the crude. Conoco has indicated that for some of its bids it only received one bid. This clearly cannot serve to measure the market. Market value is established by the interaction of many buyers and sellers. The interaction of a single buyer and a single seller will seldom lead to market value. It has been the longstanding experience in California that due to the proprietary ownership and control of the pipelines, there is usually only one buyer for an independent producers' crude oil and that producer typically does not receive market value. A minimum of 4 bids should be required for any tendering program.

Third, there is a built-in incentive for companies not to bid market prices for bid outs. Industry will be fully aware that such bids would set prices for 100% of royalty crude. The motivation thus is to bid low prices. It is in Conoco's interest to receive low bid prices. Conoco is a net buyer of crude oil and therefore it desires lower prices on the bid-outs on which to value a large percentage of crude oil which it internally transfers. Conoco's motivation is to ensure that it maintains the royalties for internally transferred crude to be as low as possible. Accordingly, Conoco's bid-outs are likely to achieve prices significantly lower than market price.

Conoco's bid prices for certain offshore production reported in its comments submitted to the MMS indicate prices below regional spot prices. As shown in Table 1 the difference in the prices received by Conoco versus the LLS spot price has increased over the three-month period, an indication that the bid prices are not responsive to changes in market value.

Table 1
Comparison of Conoco Bid Prices for Certain Offshore Production with LLS Spot Price

	Ewing Bank/ Eugene Island*/ Grand Isle	Light Louisiana Sweet Monthly Average Spot Price	Difference
April 1997	$19.32	$19.54	$0.22
May 1997	$20.19	$20.87	$0.68
June 1997	$18.38	$19.20	$0.82

*There was no price quoted for Eugene Island in April of 1997 as a result of the first bid occurring in May 1997.

Source: Conoco Supplemental Comments, dated August 1, 1997; Platt's

A bid-out program will entail a large administrative burden on the MMS to audit and review the bidding program of each company that chooses to utilize such a program to establish royalty value. Criteria such as the bid volume and the minimum number of responding bidders necessary to result in a competitively determined price would need to be monitored by the MMS, for each company and for each pricing district. In addition, the bid process would require on-going auditing since the bid program is a repetitive process. Conoco, for example, typically contracts the volume for six months.

MMS would have to monitor the type of crude oil determined as being representative of a given pricing district. If the quality of the crude oil tendered for bid differs from the quality of the majority of federal royalty oil produced in the area, the resulting bids may result in a lower or higher value for the royalty oil and, therefore, would not be representative of the value of the federal royalty oil in a given area. The MMS should consider the potential inherent difficulty in applying such a bid price as a regional benchmark.[1] Given the application to a broad geographic area, this methodology may still require adjustments, such as for location or gravity, in order to determine the price of crude oil at the lease as opposed to the price of the crude oil

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[1] Several commenters on behalf of industry have insisted that there exist individualized supply and demand factors at the lease that result in a "range" of prices as opposed to one value at the lease and therefore the MMS index methodology is inappropriate since it is largely based upon one value. However, the "regional" benchmark is itself essentially one value that would be applied over a range of leases in a given pricing district. While we do not agree that such individualized factors exist, there is an inherent contradiction in industry's position on this issue.

actually bid on[2]. Also, as Conoco has pointed out, there exist those areas where a bid program is not recommended and there they use a regional value to apply to particular fields or leases.

As to California specifically, there is no reason to believe that there exists, or will exist, conditions capable of supporting a multi-bid competitive market based tendering system.

Alternative 2: Series of Benchmarks[3]

The second alternative outlined in the September 22 notice is a series of benchmarks that a producer could use to calculate royalty payments for production not sold under arm's-length transactions. Each of these benchmarks or methodologies has serious problems that would adversely affect the value of royalty payments on federal crude oil in California and will lead to royalty payments that are based on posted prices which we know do not reflect market value. Each method is inferior to the original index methodology and would not produce prices that are close to market value. The methods would prove to be significantly more burdensome administratively to the MMS.

Benchmark 1:

The first benchmark under Alternative 2 is essentially

[2] Given the probability that adjustments, such as for location and quality, would need to be made to the value of the regional benchmark so that it is representative of specific crude oils over a number of leases, this methodology becomes one that is quite similar to the index methodology. Unlike the index methodology however, the regional tendering benchmark would be significantly more burdensome to the MMS since it would require the MMS to verify all facets of the program.

[3] Our understanding of the proposed benchmarks under Alternative 2 stems in part from Exhibit Four of the Independent Petroleum Association of America submission to the MMS dated August 1, 1997 as well as from the description in the MMS Notice.

the same methodology as described in Alternative 1 above and is objectionable for the same reasons. The value would be based on outright sales of like-quality crude oil in the field or area via a bid-out program.

Benchmark 2:

The second benchmark would allow the lessee to calculate royalties on its or an affiliate's arm's-length purchases from producers at the lease in the field or area.

This alternative will be administratively burdensome to the MMS since it would require that the MMS verify every one of those transactions to validate that they are in-fact arm's-length in nature and of sufficient volume to be representative of market value. Industry practices make it extremely difficult to validate that such transactions are arm's-length outright purchases. Often times, transactions that on the surface might appear to be outright purchases are not so. For example, many exchange transactions are structured as separate purchase and sale contracts when they are really linked. Linked transactions do not necessarily reflect market value for the crude oils being exchanged. As the MMS noted in its January 24, 1997 Proposed Rules, "the prices stated in an exchange agreement may not reflect actual value. For example, if the market value of oil were $20 per barrel (bbl), the two parties to the exchange could price their oil at $18 bbl. The parties can insure that each remains whole by using a location/quality differential in the agreement."

The industry's use of balancing agreements also results in the price reported in a purported outright purchase being suspect. A company might engage in an outright purchase or sale that could be linked either implicitly or explicitly to another transaction. The company might purchase barrels of crude oil with the understanding it is to sell an equal volume to the other company. When companies have balancing agreements, they have no incentive to insure that the transaction prices reflect market value.

The second methodology would result in low royalty values and would require an extensive and costly auditing process. It is in fact these exact issues regarding outright purchases and sales that were the original motivation for moving away from gross proceeds as the basis of federal royalty payments.

Benchmark 3:

The third benchmark would allow royalty valuations to be based upon outright arm's-length sales of third parties. This benchmark is plagued with similar problems as described under benchmark 2 above. Such a methodology would require substantial oversight on the part of the MMS to insure that such transactions are in fact outright sales, are arm's-length and whose prices are reflective of market value. Transactions that appear to be outright sales in actuality may not be such. For example, buy\sells, crude oil "calls" on production and balancing agreements are not outright sales but often appear to be. As the MMS noted in its original Proposed Rule of January 27, 1997, "the widespread use of exchange agreements and reciprocal sales as well as difficulties with relying on posted price, cast doubt on the usefulness of many apparent arm's-length sales prices as a good measure of market value."

In the case of California, additional factors have historically caused depressed transaction prices. The limited number of buyers of crude oil and their control of pipelines have resulted in the undervaluation of California crude oils. Three major oil companies who post prices in California own three heated pipelines and operate them free from common carrier requirements. Thus, the pipeline owners can dictate the terms of access to their pipelines, including the price they will pay for oil. These pipelines carry federal royalty crude oils. Pipeline control by a very few buyers permits them to underpay for their crude supplies. The price they pay is typically the posted price. Even when oil companies have paid prices above posting, these prices have remained below the price of ANS. Independent refiners find it difficult to pay much more for California crudes than the majors pay if they want to stay competitive with major oil companies. Historically, the gross proceeds method based on outright sales has resulted in prices substantially below the spot price of ANS, and it is unlikely to achieve parity with ANS prices in the future. We continue to recommend that the MMS maintain the index methodology based on ANS to value federal royalty payments for California and Alaska.

Benchmark 4:

A benchmark based on Royalty-in-Kind (RIK) sales of federal crude oil is also not acceptable in California. The price achieved for RIK sales would be below market because of private ownership of the heated pipelines.

Attaining lease level prices based upon an RIK program would result in a process more cumbersome than the index methodology. Unless the MMS intends to engage a wide-scale RIK program of multiple crude oils, thereby attaining RIK prices for crude oils in different geographic areas, the prices the MMS received still would have to be adjusted for quality and location differences as is the case with the index methodology originally proposed by MMS. Also, even if MMS employed such a RIK program, there is the likelihood that MMS would not receive market value for the crude oil it sells. Review of historical RIK sales data by the MMS indicates that it has not received market value. Also the experience of others, such as California, Alaska, and Texas that have attempted to employ such programs have not met with overwhelming success and have often failed to obtain prices reflecting market value. Indeed, the administrative burden and costs associated with such a large scale RIK program would far outweigh any possible benefits associated with such a program.

Benchmark 5:

The last benchmark is a netback method that would employ price information from the nearest market center or aggregation point adjusted for location and quality. This method is not described in detail in the notice, but we believe that it refers to spot quotes at locations such as Cushing, Oklahoma, Midland, Texas, St. James, Louisiana or others. Such a methodology would not function well in California since spot prices of California crude oils have not historically reflected market value as a result of relatively thin participation in such markets. Only two to three transactions per month occur in the spot market in California and the prices quoted tend to simply reflect posted prices. Representatives from the major price reporting services have confirmed to us that these markets are very thinly traded and therefore, such prices would not be a reliable indicator of market value. On the other hand, California refiners have consumed ANS in very large quantities and the spot price of ANS is reflective of the market value due to the large number of transactions that take place on the basis of this price. Therefore, the spot price of ANS is the appropriate benchmark on which to value California crude oil production.

For markets outside of the West Coast, this alternative appears to give greater weight to the regional aspects of crude oil in contrast to a NYMEX based index, since NYMEX is only quoted at one location, Cushing, Oklahoma. However, in fact these two methodologies should theoretically arrive at essentially the same value. In today's market spot prices are largely influenced by NYMEX prices. For example, one of industry's consultants, Marshall Thomas writes in his 1996 article "One Way or Another, Crude Oil Pricing Comes Around to Futures,"

> [t]he published cash market quotes almost universally used in crude oil contract formulas are essentially a proxy for the baseline level of global oil prices that are determined by the futures market. . . For example, an $18 per-barrel total crude oil price for an individual grade reported by a pricing service may in reality consist of a $17.50 a barrel benchmark futures quote, and a plus 504 spread differential evident on the cash market. . . This means that the formula contract price which is linked to the cash market on the surface is in reality tracking the futures market more than anything else.

The index methodology originally proposed by MMS accounts for the differential or spread between the NYMEX Cushing market and other geographic markets and relies on spot prices for specific areas as part of the adjustment process. Therefore the value that one determines via the NYMEX methodology would closely mirror the value one would determine using regional market center prices. Therefore we would endorse either the NYMEX or the regional spot price methodology.

If in fact the MMS, when referring to price information from the nearest market center, is not referring to published spot prices but rather actual prices reported by individual companies, we would once again suggest that this would prove to be administratively burdensome and costly to the MMS since MMS would need to verify the prices actually paid through an audit process and ascertain whether such prices were truly reflective of an arm's-length environment. We believe that the NYMEX index or regional spot price methods are superior in determining market value and would require far less administrative and audit burden.

Alternative 3: Geographic Indexing

The third alternative suggests that the MMS establish value based on geographic indexing employing data collected by or internal to the MMS. Once again, this would prove to be administratively difficult for the MMS. The MMS would need to verify the regional price data presumably gathered from companies reporting prices for arm's length transactions. This could prove to be a time consuming process thereby prohibiting the MMS from publishing the price data in a timely fashion. In comparison, NYMEX prices (or ANS spot prices for the West Coast benchmark) are published daily and do not require that the MMS conduct audits to verify the accuracy of the data. Moreover, this alternative would delay payment of royalties until MMS could establish value based on geographic indexing.

Alternative 4: Location and Quality Differentials

In its September 22, 1997 notice, MMS has requested comments on the issue of quality and location differentials and how one can make adjustments to index prices to account for differences in location and quality of different crude oils. The State of California repeatedly has taken the position that adjusting the spot price of ANS to place it on a comparable quality to California crude oils is a relatively easy task and in the past the State has offered concrete proposals on how to make such adjustments. We recognize that adjusting for location, i.e., transportation costs, is a more difficult process, but in these comments we have developed a proposal to adjust ANS values for location/transportation costs.

Quality Adjustments:

The State of California has consistently stated that the use of information from common carrier pipelines such as the Four Corners Pipeline system and the All America Pipeline are an appropriate, market-based method for computing quality adjustments between ANS and California crude oils. These quality adjustment factors are used everyday by many different participants in the industry (producers, refiners, brokers, etc.) to establish the monetary value of gravity and sulfur differences of crude oil moved through these pipelines. More significantly, however, is the fact that these same companies also use these quality adjustment factors in exchanges involving a wide variety of crude oils and in the manner in which they evaluate quality differences across a broad range of different crude oils.

One industry commenter has argued that gravity differentials and sulfur banks cannot be used across widely different types of crude oils because such adjustment factors were designed for small variations in quality. This is simply untrue. First, the price/gravity differential across all fields in California is approximately equal to the gravity price differential used to adjust for differences in gravity for a particular field. This indicates that the variation in quality as measured by the gravity difference across widely differing fields in California is the same as the gravity differential within a field (and generally close to the gravity banks in the Four Corners and All America Pipelines). Second, the use of the gravity price differential or the gravity bank value differential by many companies in exchanges involving widely different crude oils indicates that the companies themselves recognize that these factors can be used to value differences in quality across widely differing crude fields. Finally, the gravity banks themselves anticipate application over a wide range of gravity levels because they publish such adjustment factors in their tariffs over a wide range of gravity levels.

Recently, another commenter argued that increasing levels of imports of foreign crude oil into California makes not only the use of the ANS benchmark unreliable but also the application of gravity differentials subject to wild swings depending on the volume of imports. Data from the Energy Information Administration on crude oil imports into California over the last two and a half years do not suggest any trend toward increasing imports or an increase that could likely influence relative quality differentials. Imports into California in 1995 represented about 7 percent of total crude runs and came from various countries including China, Ecuador, Kuwait, Saudi Arabia and Venezuela. In 1996, imports came from the same areas and represented approximately 6 percent of total refinery runs. For the first half of 1997, imports have again represented about 6 percent of refining runs in California and have come from such diverse areas as China, Australia, Ecuador, Chile, Iraq, and Venezuela. Given the diversity of sources and low volumes of imports into California, such imports could not have a strong influence on relative crude values of California crude oils.

Thus there is no reason why MMS should not go ahead and use the gravity factor in the Four Corners and All America Pipeline tariffs as an appropriate, market-driven basis for adjusting for quality differences between ANS and California crude oils. These factors are changed periodically (the gravity bank in the Four Corners Pipeline has changed as often as monthly), and they reflect a market-based method for valuing differences in crude oil quality.

Location/Transportation Costs:

The State of California agrees with the general premise that the index value should be adjusted for the actual cost of moving crude oil from the lease to the market center. Although we agree that conceptually collection of such information from the companies should prove useful in determining actual costs, the reality is that the "Oil Location and Differential Report" as originally envisioned by MMS is somewhat burdensome and would require extensive audit and verification of the underlying information. We reiterate our position that the only type of relevant information for determining transportation costs should be derived from the transportation differentials (or location differentials) that apply to "in/out" exchanges, i.e., exchanges of the form "A places crude in B's pipeline and B delivers an equal volume of the same or similar crude back to A at a point further down the pipeline." Other exchanges containing location differentials in which the crude receipt and delivery points are not on the same pipeline do not necessarily provide meaningful information for determining transportation costs from lease to market centers.

In our experience in California there are a significant number of such "in/out" exchanges so that meaningful transportation cost factors from a lease area to a market center can be developed. In fact, many such transactions do occur at the lease and involve movements directly to market centers. Therefore, it may be possible to develop transportation cost factors from particular producing areas in California to market centers without necessarily worrying about particular aggregation points.

Another important and somewhat unique fact about federal royalty production in California is that it is concentrated in only a few areas and thus there is no need to develop a large number of different transportation cost factors involving areas where there is no federal royalty production. For example, onshore royalty production in California is concentrated primarily in the southern portion of the San Joaquin Valley. Approximately 80 percent of onshore federal royalty production comes from the Midway-Sunset/Cymric/McKittrick area and another 9 percent comes from the Lost Hills/ Coalinga/Kern area. This leaves only about another 10 percent and much of that comes from the Scope/South Mountain/Placerita area. Thus we would propose the use of geographic zones, keyed to the areas in which federal royalty production is concentrated as the basis for computing transportation costs. Attached to these comments is a schematic map of California depicting the proposed zones that would be used for onshore California royalty production. Note that a similar concept is also applied to OCS production although this is complicated somewhat by the limited transportation options for some locations. Many of the OCS fields, therefore, represent separate transportation zones.

The next step is to determine what the proper transportation costs should be for each zone. As an initial starting point, we would propose the use of certain transportation cost factors by zone based upon data we have compiled in the course of the Long Beach litigation, various audits of oil company contracts, and other information relating to transportation costs.[4] These data are from "in/out"

[4] MMS has had the opportunity to review these records as part of the Interagency Task Force's investigation of California royalties. In addition data from the *Reserved Pipeline Case* on in/out exchanges is publicly available.

transactions for various areas in California and provide the basis for an average cost figure for transportation shown below. From this data we can determine the approximate cost to move crude oil from certain areas such as San Joaquin Valley to refining centers in Los Angeles and San Francisco. In addition, we have estimated the cost to move heavy California crude oil through heated pipelines on a per barrel mile basis which gives us a basis for applying transportation costs more generally throughout the state including for OCS produced oil. The proposed transportation cost factors by zone are shown in an attachment to these comments, and we believe are quite consistent with actual transportation costs. Furthermore, we believe that the method proposed herein is consistent with the approach for deducting transportation costs taken by Chevron, one of the largest royalty payors in California, in its settlement of royalty issues in Texas.

In addition, we have taken the approach as outlined in prior comments that the transportation destination used in deriving this adjustment factor should be the nearest (and most economic) destination. Also, we would propose that these transportation cost factors be escalated at a rate not to exceed the annual increase in the "Fuels Power Index" of the Producer Price Index. This index measures increases or decreases in the cost of energy fuels and electric power which are the primary components in the cost of operating a pipeline, and thus should serve as a reliable means of tracking changes in the cost of transportation.

Finally, for crude oil that is trucked to a gathering or aggregation point, we would allow an additional deduction of $0.25 per barrel consistent with practices elsewhere.

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Table 2

California Transportation Zones and Cost Factors

ONSHORE AREAS:	RATE ($/Bbl.)
Northern San Joaquin Valley (180-240 miles)	$0.70
Belridge north, including Lost Hills, Coalinga, Kettleman	
Southern San Joaquin Valley (120-150 miles)	$0.50
McKittrick south, including Cymric, Midway-Sunset, Kern, Mt. Poso	
Ventura County (55-90 miles)	$0.35
Sespe, Placerita, South Mountain	
L.A. Area (0-40 miles)	$0.20
Sawtelle, other areas in L.A. Basin	
OFFSHORE AREAS:	
Beta	$0.75
Santa Clara	$1.20
Dos Cuadras, Carpenteria, Summerland	$0.50
Hondo (Santa Ynez Unit)/Pt. Arguello	$1.50
Pt. Pedernales	$0.75

All costs include gathering costs

Alternative 5: Index Pricing Utilizing Published Spot Prices

This alternative was proposed by one State commenter who suggested that such a methodology would simplify the process without sacrificing value. As we have already noted, we support the use of the ANS spot price to value California crude oil. ANS is the best benchmark for valuing West Coast production as a result of its role as the marginal source of crude oil for West Coast refiners and the fact that all refiners use it as the basis for making decisions on what crudes to run in their West Coast refineries. The geographic isolation of California precludes the use of NYMEX or other east of Rockies benchmark crude oils as a constructive basis for valuing crude oil produced on federal leases. Also, as mentioned above, spot quotes of California crude oils are inherently unreliable due to the minimal volumes traded and such spot prices would not serve the interests of the MMS in terms of obtaining market value as a basis for royalty payments.

For production east of Rockies, as we noted above, regional spot prices are largely influenced by NYMEX prices. NYMEX prices serve as the baseline for spot cash market quotes and it is the differential between NYMEX and spot quotes that indicate to the market the relative difference in prices among crude oils produced in different areas. Various commenters on the MMS proposed regulations have argued that geographical diversity of oil markets in the U.S. makes it impossible to rely on a single benchmark to value royalty produced throughout the U.S. Nevertheless, one cannot ignore the fact that refineries and pipelines are strategically located so that crude oil can be efficiently moved from producing areas to population centers where refined products are produced and marketed. The demand for crude oil is derived from the demand for refined products, and to the degree that various crude oils compete for the demands of refiners, the price of those crude oils will be determined by the same or similar supply and demand factors. Thus, for example, refiners in the Midcontinent area consider crude oils produced in Texas, New Mexico, Wyoming, Montana, Oklahoma, Louisiana, not to mention foreign crude oil, as potential substitutes depending on price, quality, and transportation costs. Ultimately, the price buyers are willing to pay for these crude oils at the lease is determined by overall supply/demand factors which exist throughout crude oil markets east of the Rockies. These same supply and demand factors drives daily pricing for the New York Mercantile Exchange contract for light, sweet crude oil and regional spot prices are then priced off of the NYMEX price.

Therefore, whether one uses one benchmark, i.e., NYMEX, or regional spot prices as benchmarks, the value attained should essentially be the same since the NYMEX methodology as proposed by the MMS accounts for the differential between major aggregation points and Cushing, Oklahoma (the NYMEX location for crude oil contract delivery.) A methodology based on regional spot quotes, however, would not necessarily result in a "simplified" approach to valuing crude oil. The NYMEX methodology results in a more standardized approach since everyone would start with one value, as opposed to the many regional spot quotes, and then work back to the lease value. We believe this standardized or streamlined approach to be the least burdensome to the MMS.

Very truly yours,

JOHN R. CALHOUN, City Attorney

By: James N. McCabe, Deputy

JNM:pw

Addendum

Comments Regarding IPAA'S Response

Even though IPAA sent no representatives to MMS workshop in California, IPAA, for reasons that are totally unexplained, strongly supports the continued use of gross proceeds valuation for arms-length transactions for California production. IPAA's assumptions which support its proposals are clearly not applicable to California. For example, IPAA contends that no representative at the workshop suggested that "captive markets" occur more than infrequently. To the contrary, California's representative at two workshops emphasized that because of the private ownership of the heated pipelines in California, producers are captive to pipeline owners to transport their crude to market. The owners of their pipelines are also posters and it has been the longstanding tradition in California that posters do not pay more than posted price for crude oil production in California. California's concern is thus very real and has been expressed numerous times both in the workshops and in writing to MMS.

At the heart of IPAA's misguided efforts to establish regulations which would obtain less than the fair market value for federal crude oil is the refusal to recognize that huge volumes of crude oil are traded at the index prices recommended in the MMS proposed regulations. The index crudes, NYMEX and ANS, are widely traded and their prices publicly reported. These prices represent very real gross proceeds and not theoretical values. IPAA also would like to ignore spot prices publicly reported for transactions at market centers in the mid-continent area.

IPAA also ignores the fact that gaming does exist presently in buy/sells and exchanges. Even IPAA would have to admit that even if Company A sells crude oil from Field X to Company B, and Company B sells a similar volume of crude from Field X to Company A, that the prices obtained by A and B in these transactions would be suspect for purposes of determining the royalty prices to be paid under the first of IPAA's proposed RVP's. But the problem is the same if Company A's sales to B occur in Field X and Company B's sales to A occur in Field Y. Both A and B would have an incentive to pay lower royalties and thus an incentive to ensure that the crudes from Fields X and Y are below their market value. As long as the volumes of the crudes are equal and provision is made to equalize quality through quality adjustments, the purchases and sales are suspect for purposes of determining royalty payments.

As indicated, IPAA reluctantly concedes that there are some examples of captive markets, but contends that they are few in number. In fact, the California market has traditionally been recognized in the industry and particularly by independent producers as rife with captive markets because of the private ownership of pipelines. While although some of the pipelines hitherto private have become common carriers, the three major pipelines in California which are heated and which are used to transport heavy crude from the San Joaquin Valley are privately owned. The owners of these pipelines are free to set any conditions on the use of their pipelines including refusals to transport crude for others at any price. Thus, producers serviced by these pipelines can and are forced to sell their crude oil to the pipeline owners at prices set by the pipeline owners. Even where fields are serviced by common carriers, crude production often can only be sent to one refinery. This is true of the former Unocal, now Tosco, pipeline in the Santa Maria area. This pipeline carries OCS crude.

Although the first two RVP's proposed by IPAA are a move in the right direction in requiring quantities of like quality crude, they do not go far enough. The significant quantities are measured in terms of the independent producer's production in its field or area and not in terms of total production in the field or area. Even the requirement of a volume weighted average price weighs only the purchases or sales of the producer and not the purchases or sales of other players in the same field or area. Accordingly, IPAA minimizes the audit burden because it rules out precisely the type of data which creates the audit burden, namely sales of similar crude in the same field or area. IPAA ignores the possibility that sales or purchases of federal royalty oil could be significantly lower than sales of other crudes in the same field or area. It is precisely because of this possibility that MMS proposed gathering information concerning purchases and sales of crudes other than federal royalty oil in the same field or area.

Finally, IPAA's efforts to avoid applying the NYMEX scheme to an exercised call fails completely. A call is considerably different than a long-term sales contract and it represents consideration in the sale of a producing property. Whether exercised or not, it represents a value to the producer. Apparently IPAA would place the burden on MMS to show that the producer accepted a lower than market price in exchange for up-front consideration. This, of course, MMS could not do short of an enormous expenditure of money.