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April 17, 1997

David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165
MS 3101
Denver, CO 80225-0165

Re: Proposed Rules
Department of the Interior
Minerals Management Service
30 CFR Parts 206 and 208
62 FR 3742
Establishing Oil Value For Royalty Due on Federal Leases and on Sale of Federal Royalty Oil
January 24, 1997

Dear Mr. Guzy:

I appreciate the opportunity to provide the following comments regarding the proposed rule for establishing oil value for royalty due on federal leases and on sale of federal royalty oil. SPC has its headquarters in Houston, Texas. We are one of the largest independent gatherers and marketers of crude oil in the United States. SPC employs over 950 people with operations in 15 states. We operate more than 2,400 miles of active crude oil gathering lines and pipelines. SPC operates a fleet of more than 300 tractor trailers to gather crude oil. SPC also has crude oil tankage at 154 onshore terminal locations plus 12 marine terminals.

As an independent gatherer and marketer, neither SPC nor any of its affiliates, including its parent, Ashland Inc., own or lease significant crude oil producing properties. SPC holds no federal lease interests and no operating interest in any crude oil producing field. SPC is a third party purchaser of crude oil; SPC is neither lessor nor lessee. SPC gathers and resells crude oil in downstream markets, moving the oil in its own system via its gathering lines or trucks, or contracting with other companies either to exchange oil or to function as a common carrier. As part of its purchase contract obligations, SPC often pays federal royalties as a payor on behalf of lessees or operators from whom we buy crude oil. SPC pays royalties on the same basis as payment to the field production operator, which is an arm's-length negotiated price. About a third of SPC's crude oil purchases are resold to Ashland Petroleum Company, an affiliated refining division of SPC's parent company. The majority of SPC's crude purchases, however, are resold to unaffiliated refiners and other buyers in downstream markets. Our margin, of course, is the difference between the price we pay in the field or other location and the resale price downstream.

SPC Competes To Purchase Crude Oil In the Producing Field

A key point I wish to convey today is one that appears to be ignored, if not rejected outright, by the proposed rule. The point is that SPC and many other companies compete fiercely to purchase crude oil at the lease. Many willing buyers are active not just in the major fields, but also in the hundreds of out-of-the-way locations where crude oil is sold in truckload quantities and where our transportation costs of purchased crude are especially high.

SPC will buy production volumes from often remote locations, aggregate the crude oil into larger volumes in our inventory and deliver the oil to downstream resale markets. SPC thus helps create a market for even the marginal producing well. SPC's purchasing service provides many lessees an efficient alternative to the cost of transporting crude oil themselves, which might otherwise prove too expensive for many types of wells. As a purchaser, we take the oil we buy into our various inventory locations and generally resell different volumes of oil at other inventory locations we maintain. This aggregation service is a key value we add as a midstream entity that the proposed rule erroneously fails to consider and recognize.

SPC Would Be Seriously Disadvantaged By the Proposed Rule

SPC is concerned about the proposed rule valuing federal lease production even though SPC holds no federal lease interests. If the rule were unfair, you might suggest that SPC could simply stop buying federal crude, or at least stop paying royalties on behalf of lease holders as part of its purchase arrangements. However, a rule that disallows negotiated prices in oil valuation would create inefficiencies in the general market and would be particularly unfair to midstream companies such as SPC. SPC negotiates with crude oil sellers taking into account various local factors affecting price, including quality, gravity, location, lease access, and numerous competitive factors, including resale market conditions, supply and demand, and other considerations. Another consideration may be that SPC, for example, might be willing to pay a higher price for longer term contracts, such as six months. Of course, if SPC's price is not considered adequate, then neither the operator nor the lessee is compelled to sell to SPC. Alternatively, non-operators may be able to take their royalty in kind under many leases. SPC should not be harmed by being forced to pay royalties based on unrelated future sales by unrelated parties in unrelated downstream markets. SPC should be able to negotiate or bid for federal lease oil based on SPC's unilateral assessment of the value of oil under circumstances where the seller is free to decline SPC's offer. Why should SPC be forced to let the NYMEX dictate oil prices SPC must pay in production fields where circumstances are both different and far from Cushing? Again, the lessee or the operator can reject any offer from SPC and sell to others.

In the case of an exchange between SPC and an operator, the MMS should have a concern only if the lessee/operator is not receiving a competitive price at the lease. If the MMS is concerned that a price on the lease level side of an exchange is somehow unfair, then the MMS might consider asking the operator to obtain both an outright purchase offer as well as an exchange offer from buyers such as SPC. As long as the lease side of an exchange is transacted on the same basis as an outright sale to SPC or other buyers, then the MMS has the assurance that no overlooked value exists for its royalty oil. Alternatively, the MMS may consider taking its royalty in kind to eliminate any concerns when and where it has the right to do so.

Since SPC buys oil only in arm's-length transactions, the proposed rule for valuation of crude oil using downstream futures prices with artificial transportation adjustments layered on would complicate SPC's business activity and greatly increase transactional costs. The MMS should simply look to offers or bids accepted from third party purchasers as the reference price. The market offered by the third party purchaser should have been highlighted by your consultants since SPC's and its competitors' prices necessarily reflect and respond to the ultimate resale markets. Competition among the third party purchasers is the best indicator of a fair and true value for crude oil in the field.

To abandon negotiated prices as a basis for royalty values would erase the protection SPC would have from aberrant or runaway paper trade activity on the NYMEX. The MMS or other parties are free to buy or sell on the NYMEX and should not impose a synthetic NYMEX trade through SPC at no cost or risk to the MMS via these proposed rules. Of course, if MMS wishes to hedge upstream production values using a downstream futures price, it should pay the cost for hedge sales by selling NYMEX contracts through a broker.

We believe that the proposed rule, if implemented, would seriously harm our business and the efficiencies we bring to the overall domestic oil markets. The impact of a federally imposed price that differs from competitively negotiated prices would likely be much broader than its impact on valuing federal lease crude for royalty purposes. A federally set price would tend to become a general benchmark with other crude sellers.

The central theme of the proposal appears to be that purchasers and marketers of crude oil such as SPC are somehow reaping artificial profits, thereby taking wealth that rightly belongs to royalty owners. The proposed rule denies a merchant such as SPC the value it adds to crude oil in its role between operators and refiners and other buyers downstream. The proposed rule essentially limits the return on such added value to the "actual costs" of transporting oil from the field to a downstream location because only actual costs would be allowed to the first aggregation point, or to an alternative location if no aggregation point is used. Such actual costs would even have an artificial limit placed on them. *See* 30 C.F.R. § 206.205.

Thus, under the proposal, the MMS generally would be paid the difference between a downstream price and the purported "actual cost" of getting the oil to the downstream market. The proposal rejects the fact that, in addition to this so-called actual cost, a tremendous level of economic and environmental risk is involved in moving the oil downstream. In our transactions including exchanges, SPC assumes risks of line loss, price volatility between the time of purchase and the time of resale, exposure to risks of spills and other environmental liability, credit risks, volatility in customer demand, and many other market-based risks that arise between the date of production and the date of a downstream sale. Even foreign politics and competition of imported oil can have a tremendous impact on crude price movement. For example, when the market believes Iraq will be allowed to sell additional crude in the open market, crude prices would likely decrease because of the extra supply. Although the proposed rule is based in part on a NYMEX futures price that would account for certain changes in world prices among other influences, the proposal appears to deny marketers any compensation for the risk of price movements between the date of purchase and the date of delivery downstream, and fails to account for rapidly changing local factors that affect crude prices. If the MMS wishes to share in the value added after the point of sale at the wellhead or some other location in its royalty calculations, it should also participate in the associated downward price movement risk and other risks. The proposed rule ignores the value of the services we and other midstream companies provide in exchanging oil with downstream customers. Indeed, the rule could be viewed as a new federal tax on SPC's business activity.

From the viewpoint of a company buying and selling crude oil everyday, I have to assume that the authors of the proposed rule have not been told by the consultants how complex and irrational the formulas would be when applied to the real world which includes payors and not just lessees. For example, depending on where the crude oil flows, multiple different adjustments would be made to the NYMEX-based price East of the Rockies. Crude oil at the wellhead would have a different price formula applied for royalty valuation purposes depending on whether it (1) moved directly to a market center, (2) moved to an aggregation point, or (3) moved directly to a refinery or other alternate location. Yet another different price formula would apply if the particular lessee involved was an independent producer who had not purchased crude oil in the two previous years. A question that will arise is whether a third party purchaser acting as a payor may rely on representations by the operator as to its status with respect to all of these formula determinations.

If you are concerned with audit burdens associated with determining royalty value consider, for example, crude purchased from two wells immediately adjacent to each other, one leased by an integrated company and the other leased by an independent. The oil produced would be valued using entirely different formulas. This scenario would apply to all federal and Indian leases.

In addition to the fact that various different formulas could apply, each of these proposed formulas would produce a variety of crude values at the wellhead depending on how far away the barrel is to be transported and how costly it is to transport along the particular route selected. Thus, under any given applicable formula (for example the market center formula or the aggregation point formula), a barrel that is to be moved 20 miles from the wellhead would have a different value at the wellhead than a barrel that is to be moved 40 miles away, and so on. If along the way a truck or a barge were to be used to transport the barrel, it would have different value at the wellhead than if it were to be moved via a pipeline. It is as if the consultants on the proposed rule somehow assumed that barrels produced from any particular field would always be transported to the same place in the same way such that crude oil values at the wellhead would be predictable. However, the transportation methods and costs for a particular barrel at the wellhead can vary widely, and would be unpredictable. Would this approach abolish efficient exchanges at the lease level in favor of transportation direct to market centers?

It appears to SPC that your consultants have no concept of who we are, what we do, and how the real world of crude oil buying and selling works. SPC is a crude oil purchaser. When one of our buyers receives a phone call from a producer offering to sell SPC oil production from a lease, he or she needs to make a quick business decision or lose the opportunity. A variety of factors affect that judgment at any particular time. The buyer needs to consider what, for example, the postings are at that moment, who the competitors might be, location difficulties, what routes and means exist to move the oil, risk of non-production, the term of the deal, and what demand exists at the various potential distribution points. If a major flood occurs on the Mississippi River, for instance, the buyer might need to consider the impact on barge capacity. If a major winter storm occurs, he or she might need to consider the impact on trucking and handling efficiencies. A fire at a major distribution point could disrupt some or possibly all routes for the crude oil being offered.

SPC resells crude oil in downstream markets at margins that are often razor-thin. We have lost money on some deals in the resale markets. If SPC is paying federal royalties on crude oil it buys, our own buyers need to know at the time of purchase what that oil will cost to help make the acquisition decision and so that the oil can be priced for resale. The notion that a buyer must also consider a multitude of possible royalty valuation formulas and adjustments that vary depending on what type of producer is selling the oil and which of many routes the oil would travel is nonsense. He or she could not possibly make a prompt reasoned decision necessary to consider the offer.

When a buyer receives a phone call offering to sell federal lease barrels, how, as a practical matter, is he or she to know how to value it. For example, if we pay royalties on behalf of the lessee, how are we to know in all cases whether the lessee might also have purchased crude oil in the last two years, which may change the product valuation formula. Indeed, why should it matter what the lessee bought two years ago?

The Proposed Rule Unfairly Values Crude Oil Sold in the Field

In addition, the proposed rule as currently drafted would value federal lease crude oil that is sold in the production field at the same price as if it were sold at a downstream "aggregation point," which could be a hundred miles or more away from the wellhead. MMS proposes to value crude oil sold at the lease (i.e., in the field) as if it were already, without effort or cost by someone, at a downstream aggregation point in a tank. No allowance is made for the costs of transporting the oil from the wellhead to the aggregation point, or the alternative inventory cost of engaging in an exchange. Also, no allowance is made for the environmental risks, economic risks, weather impact, or the other factors that could influence the value of crude oil as it moves or is exchanged from the wellhead to this so-called aggregation point. Not only are costs and risks ignored, but no allowance is made for a fair rate of return for a company moving or exchanging the crude oil. Of course, we assume that this error in the proposed rule that disregards the role of the third party purchaser is based, not on policy, but on an omission or lack of understanding of SPC's business by the consultants.

This glaring omission regarding the valuation of crude oil that is sold at the lease, however, cannot be fixed within the framework of the proposal, and it highlights the overall major problems with the proposal. As a matter of basic free enterprise theory, the only price that is reasonably fair when valuing crude sold under a competitive arm's-length contract at the lease is the contract price itself. Oil prices in SPC's contracts are based ultimately on what a willing buyer, SPC, will pay and what a willing seller, the operator, will accept at the point of sale. Any other formulaic valuation distorts real world market forces and creates inefficiencies. No other formula could reliably account over the long term for the ever-changing factors that go into the negotiated price of crude sold in a particular field at a particular time. A formula that values crude oil at a price that is different from the price SPC negotiates with a seller creates an artificial price. Artificial prices create market inefficiencies that may in turn negatively impact the MMS. If midstream companies such as SPC curtail their business, there will be less competition at the lease. Yet, if the above-described omission were corrected, and crude sold at the lease were valued according to the contract selling price, how could the very same crude sold a few miles from the wellhead reasonably be valued under a different formula?

Prices in Buy/Sell Exchange Contracts Matter Greatly and are Valid

Another premise that is stated in to the proposed rule is that prices in buy/sell exchange contracts are not market prices and have no meaning. According to the notice, "the prices stated in an exchange agreement may not reflect actual value" because "[t]he parties can insure that each remains whole by using a location/quality differential in the agreement." SPC is one of many companies that add value by maintaining inventories to support oil exchanges and avoid transportation costs. This includes maintaining crude oil inventories at market centers. Depending on a variety of factors, transportation costs are reduced by arranging buy/sell exchanges with various sellers. SPC's transportation is generally for its own account and, as a merchant, SPC can pass on savings it obtains by avoiding as much transportation of inventory as possible. Of course the costs and price risks to SPC of maintaining the inventory must be constantly assessed.

The notion that prices in such buy/sell exchange contracts do not matter could only be advanced by someone lacking overall experience in buying and selling crude oil in today's marketplace. For example, we have encountered several occasions when an exchange partner, for whatever reason, failed to deliver promised barrels on time. Our legal remedy is often based on the price set forth in the contract. An artificially low price in the exchange agreement could be an open invitation to breach the contract. In addition, a real price, and not a nominal price, is essential to an exchange contract for purposes of both minimizing cost of cover and for settling imbalances with the exchange party, which routinely and necessarily occur--especially in the case of lease purchases. Imbalances occur in a lease purchase exchange contract because one can never know the exact quantity of crude that will be produced from a lease in any given month. Such exchanges can only be made on an approximate volume basis. Any delivery we make must be paid for at a realistic fair market price if a barrel is not delivered against it. The consultants appear to have failed to consider this significant point.

Furthermore, the notion that prices in buy/sell exchange contracts do not matter ignores the reality that these contracts often involve different qualities of crude oil being exchanged, or different delivery dates. Also, gravities may be different and the price would need to reflect the difference. Take, for example, a contract exchanging 1000 barrels per day of sour crude for 1000 barrels per day of sweet crude where one party's posted price is used to value the oil. Even if delivery dates are the same, the implicit assumption that all crude grades being exchanged in these types of contracts could be equally underpriced, and that the relative underpricing among crude grades could remain constant up to the delivery date, makes no sense. The dynamics of the market would automatically create winners and losers if the contract prices were undervalued because the spread between various grades of crude frequently changes between the date of the contract and the date of delivery.

Take, next, the example of an exchange contract wherein the identical same quantities and type of crude is being exchanged at precisely the same time, and SPC's posted price is used to value the oil. The notion that SPC's posted price might be artificially low in this example ignores the reality that the same posted price might also have been used in the sweet for sour crude deal described earlier. The theory that prices in exchange contracts do not matter breaks down because the benchmarks, such as posted prices, that may be used in exchange contracts are also used in exchange contracts involving unequal grades, quantities or delivery times. Indeed, I know of no company that deals only in symmetrical lease oil exchange contracts.

Other Comments and Legal Issues

I wish to add that if the proposed rule applies to purchase contracts already in place where we are paying the federal royalties, then the rule is also unfair because we had a right to assume that the crude would be valued based on the current regulations. I assume that whatever rule might be adopted, it would not be retroactively applied to existing contracts.

Also, in addition to the administrative costs of figuring out how to value each barrel, along with the potentially substantial new cost of additional reporting requirements imposed by the proposed rule on lessees and their affiliates, a substantial cost arises from shifting revenue away from midstream purchasers such as SPC under a formula tending to restrict their rate of return to "actual costs." The notice to the proposed rule states that under the Unfunded Mandates

Reform Act of 1995, the rule would not impose a cost of $100 million or more on the private sector in any given year. In our opinion, this statement is clearly false.

Further, the proposed rule exceeds the statutory authority of the Secretary of the Interior because it does not set the conditions regarding value of the production removed or sold from the lease. The Minerals Leasing Act gives the Secretary authority to lease public lands, and requires that any such "lease shall be conditioned upon the payment of a royalty at a rate not less than 12.5 percent in *amount or value of the production removed or sold from the lease.*" 30 U.S.C. § 226(b)(1)(A) (emphasis added). For more than seventy-five years, the term "value of the production removed or sold from the lease" has consistently been interpreted to mean the value of the production *at* the lease. However, for most federal leases, the new rule does not set conditions for value of the production at the lease, but rather, imposes a value by referencing futures contracts for crude oil at a downstream market center. Because the proposed rule exceeds the Secretary's statutory authority, it would be unenforceable if promulgated as a final rule. *See Chrysler Corp. v. Brown*, 441 U.S. 281, 308 (1979).

The new rule is also based entirely on the fallacious conclusion, contradicted by MMS' earlier public statements and the weight of available evidence, that negotiated contract prices do not accurately reflect the value of production removed or sold from the lease. In reaching this conclusion, MMS states that it relied upon "presentations by: crude oil brokers and refiners, commercial oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing." 62 Fed. Reg. at 3742. The rulemaking was the culmination of a report of an Interagency Task Force, which commissioned expert studies only from those individuals who testified for the State of California in the *Long Beach* litigation that challenged such prices. MMS' deliberate reliance on experts predisposed to reject negotiated contract prices at the lease is arbitrary, capricious, and an abuse of discretion. *See e.g., Boswell Mem'l Hosp. v. Heckler*, 749 F.2d 788, 803 (D.D.C. 1984) (recognizing that reliance on a soundly-criticized study "can obviously be an arbitrary and capricious action"); *Lloyd Noland Hosp. & Clinic v. Heckler*, 762 F.2d 1561 (11th Cir. 1985) ("It is also an abuse of discretion to base a regulation on faulty data."). In addition, by failing to identify the experts and consultants upon whom MMS relied, and failing to describe the presentations that these individuals and others made, MMS has failed to provide interested parties notice and an opportunity to comment as required by the Administrative Procedures Act. *See Lloyd Noland Hosp. & Clinic v. Heckler*, 762 F.2d at 1565; *Portland Cement Ass'n v. Ruckelshaus, 486 F.2d 375 (D.C. Cir. 1973).*

Scurlock's Proposal

We urge that the rules allow a third party purchaser and royalty payor to pay royalties based on a negotiated price. The MMS' NYMEX-based formula fails to recognize and account for the fact that, first, NYMEX contract delivery months are priced based on the simple daily average of settlement prices of (a) the near month contract for the first 20 days of the delivery month, and (b) the next month contract after the near month contract for the remaining calendar days (i.e. the last 8, 10, or 11 days of the delivery month); second, a settlement price for each day the NYMEX is closed is deemed to equal the settlement price on the last trading day prior to the day the NYMEX is closed, with the previous day's settling price applying to weekends and U.S. holidays; and, third, fair market value adjustments have not been and cannot be made for such factors as location, quality and risk, without arbitrary caps or limits on those adjustments. SPC, as an independent third party purchaser, engages in arm's-length sales of oil at the lease and should not be negatively impacted by arbitrary limits on its ability to negotiate to buy oil at the lease as I have described. Nor should MMS adopt a cap or limit on location, quality or other adjustments or differentials that a third party purchaser might obtain in an arm's-length transaction. Any such cap would penalize SPC by imposing an arbitrary limit on its ability to recover costs that exceed the cap. For example, SPC should not be restricted in passing on the full cost of common carrier pipeline tariffs. Questions regarding such tariffs should be the concern of agencies with jurisdiction over those tariffs. Cost calculations in lieu of these tariffs would cause harm to SPC as SPC would have to pay the tariffs rather than costs as calculated by the MMS.

In conclusion, I would summarize my concerns as follows:

- The best indicator of crude oil value at the lease is an arm's-length sales price at the lease such as that provided by crude oil purchases such as SPC.
- The proposed rule, however, unfairly values crude oil at the lease by grabbing substantial value added to the oil after it is removed from the lease. The MMS regulations will probably be emulated by other sellers who wish to increase the price obtained by taking value added after the point of sale which may either cause SPC to raise its resale prices or suffer reduced margins.
- The proposed rule completely fails to recognize the value of aggregation and other services that a midstream company such as SPC adds to the oil after it is removed from the lease.
- The proposed rule not only abandons arm's-length negotiated prices at the lease as a basis for royalty values, but subjects SPC to the risk of aberrant or runaway paper trade activity on the NYMEX.
- If the MMS insists on valuing lease crude oil using a NYMEX futures price, then the MMS must allow adjustments to account for all value added, as well as risks incurred, once the oil is removed from the lease. The MMS can sell NYMEX contracts itself through a NYMEX broker.
- The valuation formulas in the proposed rule make no sense, producing an infinite variety of wellhead values depending on where the oil alternatively is transported and the alternative costs of getting it there.
- Indeed, the proposed rule values crude sold at the lease as if it were already at a downstream aggregation point. The MMS is seeking a price for its share of oil higher than that received by the operator. The MMS can sell its oil in kind to independent purchasers such as SPC.

- MMS's suggestion that prices in an exchange contract do not matter, and thus may be artificial, ignores the real world market. Exchange parties may sometimes fail to deliver, which may expose SPC to a cost of cover; and also, many exchange contracts involve unequal qualities, quantities, and/or timing of delivery, which makes a fair market price essential in the contract.
- In sum, the proposed rule, if implemented, would seriously harm SPC's business and the efficiencies we bring to the overall domestic crude oil markets.
- While the MMS may see these regulations as cost controls on the majors, they are price controls on independent purchasers and merchants such as SPC.

Thank you for your consideration.

Very truly yours,
SCURLOCK PERMIAN CORPORATION

Lawrence J. Dreyfuss

Lawrencc J. Dreyfuss
Vice President and General Counsel

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