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Regulatory Affairs Department

April 6, 1998

Via Airborne Express

Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
U.S. Department of the Interior
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Dear Mr. Guzy:

RE: SUPPLEMENTAL PROPOSAL RULE FOR VALUATION OF CRUDE OIL PRODUCED ON FEDERAL LEASES 30 CFR §206, 63 FR 6113 (FEBRUARY 6, 1998)

These comments are submitted on behalf of Shell Oil Company and its affiliates, Shell Offshore Inc., Shell Deepwater Development Inc., Shell Deepwater Production Inc., and Shell Western E&P Inc. Shell has participated previously in making comments on earlier publications of this rulemaking and all those Shell comments previously filed are hereby adopted by reference.

The starting point for oil valuation should be the value of the lease product at the lease at the time it is physically severed from the well. The MMS position on value away from the lease expressed in the proposed regulation is arbitrary and capricious in that it is unsupported by any factual record which requires that valuation be moved away from the lease, it is contrary to law in that it violates existing lease contracts with federal lessees and is contrary to a long established precedent of the Department of the Interior which requires the Interior Department to value production at the lease at the time of production. MMS's own statistical records indicate that approximately eighty percent (80%) of their royalty revenue is generated from production associated with the Outer Continental Shelf ("OCS"). The OCS lease presently requires that production be valued at the time production is saved, removed or sold from the lease. The OCS Lands Act itself requires in

Section 8 that royalty value be determined at the lease at the time of production. The MMS has failed to advance any adequate factual record which justifies the promulgation of a rule which determines value away from the lease by tracking of production to distant points at great additional costs to both the MMS and the lessee in order to determine its value.

The MMS's position on valuation expressed in the proposed rulemaking reflects a fundamentally flawed understanding of the legal relationship between a lessor and a lessee. It is premised on a notion that the lessor is automatically entitled as a matter of law to assess royalty on the enhanced value of hydrocarbons away from the lease without bearing any of the additional physical risks and costs such as spill, production loss, transportation inventory carrying costs, insurance, storage costs, imbalances, administrative costs and market risks, including but not limited to value fluctuation, credit risks, over and under supply which are borne in the downstream market either by a third party, the lessee or the lessee's affiliate. The proposed regulations further fail to recognize the reality that trading center markets are inherently different from the lease market, with inherently different associated values and costs. Trading center valuations reflect the sale of large, certain quantities for deliveries at a specific future time, in a specific grade and quality, without the associated risks or costs described above which must be borne by the producer at the lease. Additionally, the availability of a plethora of trading partner and transportation options at trading centers yields a very different market than that which exists at the lease.

The basic bargain on which a mineral lease is based allows the lessor to collect a royalty assessed on value at the lease based on an understanding that the lessor, in exchange for this payment, is relieved of all of the risks and costs associated with enhanced value of the hydrocarbon away from the lease. As such, the lessor is not entitled to share in enhanced value achieved by actions taken at points distant from the lease. The current federal lease form and the currently effective federal mineral statutes adopted this approach at the time of their passage by the Congress.

The regulations grossly misstate the lessee's obligation to market. It is unlawful for the MMS to imply that an obligation to market at no cost to the lessor exists and that the lessor is entitled to a royalty on this enhanced value away from the lease without fully sharing in the costs that create that added value. The MMS has confused the requirement that the product be put into a marketable condition at the lease with the legally insupportable proposition that the producer is required to market crude oil at some distant point at no cost to the federal lessor. The requirement to place the hydrocarbon in marketable condition at the lease was formulated based on the legal presumption that value was to be determined at the lease or as close thereto as possible based on the marketable condition customarily acceptable in this area. For Shell, almost all crude oil produced on the OCS is in a marketable condition at the Lease Automatic Custody Transfer (LACT) Unit, at which point royalty volume and value is determined. Therefore, this attempt of the

MMS to move the valuation point away from the lease and to assess royalty on such a value without bearing any part of these costs incurred away from the lease is unlawful, arbitrary and capricious. This unlawful extension of the duty to market is exemplified by the early approach taken to transportation by the MMS. In the 1960s, the then USGS attempted to evade its duty to bear its fair cost of transportation of offshore production by alleging that transportation was part of the duty to market. Litigation ensued and a determination was made that the Department of the Interior is obligated to bear its cost of transportation service provided. These early cases clearly delineated the extent of the duty to market and recognized that costs incurred away from the lease by lessees (transportation) which added value were to be shared by the federal lessor.

The expanded duty to market alleged by the MMS in the proposed regulations directly conflict with its long-standing practices and interpretations on this issue, as well as deductibility of costs for services performed away from the lease that add value. In the proposed rule, MMS appears to imply a newly dawned realization that hydrocarbons away from the lease which have been blended, moved, stored, freed of leasehold risks and uncertainties, enhanced through substantial additional expenditures, and subjected to different market forces are more valuable than the same products at the lease. In fact, MMS itself from the inception has recognized this concept of enhanced value by granting manufacturing allowances for gas processing and transportation plant volume reduction as deductions from the enhanced value of the gas plant product recovered in the plant. In gas plant processing, MMS takes each of these costs back to the lease since it knows that value of the product can only be determined lawfully at the lease after deducting costs incurred to enhance value away from the lease. For gas plant processing, MMS will share in those costs only if they raise value of the gas products recovered above the value of the gas unprocessed at the lease. Through long standing contemporaneous interpretation, MMS has recognized that if some net-back methodology is to be utilized for valuation, value at the lease can be determined only after deducting costs incurred to enhance value of the product away from the lease.

The effect of current proposal's gross understatement of transportation costs results in an increase in the royalty clause above 1/8th or 1/6th by treating federal royalty oil transportation costs in a discriminatory manner contrary to the duty imposed by Section 5(c) and (f) of the OCS Lands Act. Section 5 of the Act obligates the Secretary to prevent discriminatory access to oil pipelines on the Outer Continental Shelf. The present MMS proposal specifically provides for discriminatory treatment for the royalty share in violation of that duty by mandating transportation of federal royalty oil at a cost far below that borne by other third parties transporting oil in the same oil pipelines on the same day. The rejection of tariffs promulgated in accordance with Federal Energy Regulatory Commission (FERC) regulations as the appropriate transportation allowance for federal royalty oil is arbitrary and capricious and is also unsupported by any factual demonstration in the record. FERC, the sister agency of the Department of the Interior, has promulgated procedures under which the rate to be charged for movement to the pipeline has been established to be just and reasonable. DOI's rejection of this determination without a clearly articulated factual basis is *prima facie*, arbitrary and capricious. Section 5(a) of the OCSLA mandates that the Interior Department cooperate with its sister agencies. Rates adopted in accordance with FERC procedures are entitled to deference by Interior.

The requirement to track various exchanges down to third party sales is an unlawful and arbitrary extension of MMS authority through regulation of non-lessees. In recent litigation, the MMS has asserted a right to review the records of affiliated companies at first sale to determine what, if any, impact such records might have on value determination. There is a substantial difference between the right to review records and the right to dictate and direct how records are to be maintained by a non-lessee at points far distant from the first sale and the lease. The provisions of the Federal Oil and Gas Royalty Management Act and the Royalty Simplification and Fairness Act do not create statutory authority for the MMS to so regulate non-lessees, nor do the statutes empower Interior to require non-lessees to maintain records tracking production through downstream exchanges or resales in different markets. Under law, the MMS has no statutory authority to regulate non-lessees in this manner.

The MMS tracking proposal is based on an incorrect factual assumption by the Department of the Interior that major integrated oil companies or their affiliates do not engage in third party arm's-length sales at points distant from the lease. The regulations as presently structured would require the major integrated lessee with affiliated companies to create and maintain complicated computer systems to demonstrate value received in arm's-length transactions away from the lease and away from first sale. This would require a complete revamping of computer programs in an effort to track individual barrels of oil through a continual series of exchanges and sales. Since federal and non-federal barrels are commingled, distinguishing one barrel from another is impossible. Production commingled from various federal leases have a similar loss of identity after commingling. This process would impact the method of record keeping as well as the records of a marketing affiliate since this new proposal requires tracking even if only a small percentage of sales were involved in third party arm's-length transactions. In fact, it would require demonstration of the negative (e.g., no sale) during an audit even though none took place. Presumably, it would also require either a comparison of the arm's-length value to the index value used for that portion of production not sold in arm's-length, or tracking of a portion of production stream from a lease to an arm's-length sale and another portion of the production stream from the same lease to an index value point. It is unclear under the current regulations whether one or both of these provisions would be applied by the lessee determining royalty value of split stream dispositions.

The MMS cost analysis of the implementation of the tracking provisions of these new regulations is inaccurate and flawed. The tracking of individual values of barrels to downstream third party sales away from the lease is not currently possible for Shell's and many other producers' accounting systems. Although we believe there are legal and factual impediments to even implementing this process, MMS did not accurately consider factually the cost that would be associated with the implementation of such a system even if it were possible. This is best exemplified by the fact that the proposed rulemaking does not even contain a transition provision to allow or recognize that current computer systems and accounting procedures are completely incapable of performing the tasks required by the regulations. In addition, we believe equally extraordinary costs will be incurred by MMS in digesting and attempting to use this data and that there has been an inadequate analysis of this cost impact on the agency itself. The costs of implementation of this process by MMS has simply not been accurately undertaken by MMS.

The three-tiered approach to valuation, e.g. West Coast, Rocky Mountain and Gulf of Mexico, imposes an unreasonable burden on lessees to create three separate computer system designs in order to maintain administrative compliance. No factual basis has been put into the record to demonstrate why Rocky Mountain crude should be tied to Cushing, Oklahoma NYMEX index, when as a matter of physical fact, substantial Rocky Mountain production as that production is defined in the regulations is physically incapable of moving eastward toward Oklahoma. On the West Coast, Shell has already critically commented on the use of Alaska North Slope values to determine California production. MMS is referred to Shell's earlier comments on this issue. No detailed analysis of the economic impact of maintaining a three tiered reporting system by federal lessees who own leases in the Rocky Mountain, on the West Coast and the Gulf of Mexico has been made. The short time frame provided for comment of the regulations has not allowed industry or Shell time to assess these costs and comment meaningfully.

This latest proposal of the MMS is so fraught with ambiguity and uncertainty that it makes it difficult, if not impossible, for a lessee to comply with valuation of its hydrocarbon. In this regard, the proposed rule is arbitrary, capricious and contrary to the Secretary's duty to establish value of lease production as required in the OCS lease and implementing statutes of the Outer Continental Shelf Lands Act. Shell adopts by reference the descriptive diagram of the decision process which is attached to the American Petroleum Institute comments (see, Attachment F to API comments) made on the rule. That chart demonstrates that at numerous junctures, the lessee is left with little or no guidance on how valuation is to be determined under this proposed rulemaking. Uncertainty is further exacerbated by the Secretary's suggestion that the Interior Department never be bound by any valuation directive or determination issued to the lessee since they are in a mere advisory form. This leaves the lessee as a ship adrift in a storm of ongoing controversy which may unintentionally result in overpayment or underpayment. Recent press has reported the institution of lawsuits against federal lessees alleging violations of the False Claims Act. Promulgation of valuation determination rules with such ambiguity and lack of certainty in the context of the assertion of liability under these kinds of statutes is unconscionable. MMS's current proposal reads as if it is a hedge of bets to maintain options for assessment of underpayment of royalty even when payments are made by a diligent and responsible lessee. The Secretary has a duty under the OCS Lands Act and under the terms of the lease itself to set reasonable value. With that duty there is an obligation imposed on the Secretary by law to provide a reasonable objective guidance to a lessee on how to determine that value. The proposed rule fails terribly in that regard.

Most disturbing in the proposed regulations is the total disregard of obligations imposed on lessees by other federal statues and regulations which the Secretary is obliged to enforce under the OCS Lands Act, and which directly contradict the proposed rule. For example, the requirement to solicit data on exchanges and resales made at arm's-length among competing oil companies is contrary to the Secretary's duty to enforce the antitrust laws of the United States as expressed in the OCS Lands Act Sections 5(a) and 8(c) and in MMS regulations at 30 CFR §256.46. The routine exchange of data relative to price of sale between competing lessees appears to run squarely into conflict with that provision, especially when a lessee is required to do so contemporaneously with actual sales. The MMS proposal does not even explain how the lessee would obligate the other party to an arm's-length exchange to report back to the lessee details of further downstream exchanges.

The total disallowance of tariffs for oil transportation is arbitrary, capricious and an unlawful disregard of a sister agency's regulations. Section 5 of the OCS Lands Act requires the Secretary to cooperate with other federal agencies, in this case the FERC. The FERC has established procedures for determining appropriate levels of cost for transportation. The rejection of these tariffs without any factual basis in the record to justify a lower rate of transportation when these tariffs had been set in accordance with FERC procedures for use by parties other than a lessee is arbitrary and capricious. The Secretary is obligated by Section 5(e) and (f) of the OCS Lands Act to prohibit and protect from unlawful discrimination in transportation arrangements for oil on the OCS. The definition of an acceptable transportation allowance promulgated by DOI in the proposed regulations is unlawfully discriminatory and in violation of this provision since it requires the lessee to move government's royalty production at a rate substantially lower than that provided for movement of third party production. As such, it is an unlawful exercise of pipeline rate making by the MMS to set transportation rate of the federal royalty share. The transportation provision of the OCS Lands Act requires non-discriminatory access for oil pipelines. The transportation of royalty oil on terms and conditions radically different than that borne by other parties using the same pipeline on the same day violates that provision.

No factual basis has been provided for MMS's proposal to set the value of transportation for royalty share of production below the actual value of the transportation service provided. This situation is particularly acute for offshore production where transportation infrastructure is costly. Promulgation of this proposal is tantamount to the MMS unlawfully raising the royalty rate by reducing the amount of the transportation allowance. It appears to be based on an unlawful presumption that the federal lessor is entitled to preferred treatment for transportation similar to that granted to a public utility while other third parties moving through the same pipeline on the same day from the same lease pay and deduct a higher fee for the service provided. There is no statutory basis for the MMS to assume the mantle of a public utility. Instead, traditional oil and gas law principles which have been consistently applied by the courts in interpreting federal mineral leases require the MMS to pay a fair and reasonable share of the cost of transportation. The OCS lease form itself describes this obligation for in-kind delivery as "the lessee shall be entitled to reimbursement for the reasonable cost of transporting the royalty substance". It is logically inconsistent for MMS to maintain as it has in this proposed rule that royalty value of a hydrocarbon is validated by the value paid for hydrocarbons by non-affiliated third parties while rejecting outright as the transportation allowance the value paid by these same non-affiliated third parties to move production through an affiliated line. The best measure of the cost of that cost is what other unaffiliated third parties pay to move production through the same pipeline.

The MMS's provision on limited reimbursement for transportation unlawfully interferes with the lessee's contract for sale of the federal royalty portion by imposing a term and condition on the lessee which results in an actual loss to the lessee for the cost of the transportation service paid to an affiliate for federal royalty production. There is no statutory basis or regulatory basis for the MMS to impose such a loss on the lessee as a matter of law merely because the lessee has contracted with an affiliated pipeline for movement of its production. This is especially true when non-affiliated third parties pay the pipeline's full cost to move through the line.

The MMS has now specified spot price at St. James and Empire as published by Platts as the correct index to use for Gulf of Mexico crude. However, MMS continues to provide an inadequate adjustments for transportation, quality, market differential, and location from the lease to the index pricing point. MMS is referred to Shell's comments filed on May 27, 1997, for a full discussion of the continuing flaw in the adjustments as provided in the proposed regulations.

MMS continues to use aggregation points. It is unclear under the regulations what the use of the aggregation point adds to the valuation process other than complication. Many of the aggregation points selected by the MMS are not representative of locations where actual transactions take place and, in fact, are merely points subsea at a pipeline interconnect at the bottom of the Gulf of Mexico. MMS does not address or discuss how distances are to be calculated to these obscure points and does not even consider how a lessee should prorate (if at all) a single rate cost of transportation to shore which does not charge by mile carried to the aggregation point. Two separate location/quality differentials are provided under the regulations. One from the lease to the aggregation point, and for certain transactions, from the aggregation point to the disposal point or index point. If the MMS does opt to implement its definition of reasonable, actual costs then that figure is capable of calculation from the lease to any onshore point including an index point or refinery.

As discussed in our prior comment, the data collection provided under Form 4415 appears to be fairly limited and will not be reflective of actual market conditions today since it historical in nature. MMS is obligated to allow the cost today not a historical cost based on last year's experience. The use of Form 4415 data to determine transportation from the aggregation point to the index point appears to be an unnecessary complication using historical data for today's cost at great administrative cost to the lessee as well as the MMS. See Shell's prior comments on this form.

Section 206.112 reflects an extremely naive understanding of the disposal of oil production from the Gulf of Mexico. From prolific deepwater leases such as Auger which produce almost 100,000 barrels per day, it is quite possible to have several dispositions of product produced on the same day with a variety of different transportation arrangements. As such, the MMS's proposal may require that a split stream of the same oil be tracked and granted different location and quality and transportation allowances for value back at the lease when, in fact, there is no realistic difference in the transactions themselves. This can only be classified as an arbitrary and capricious exercise of authority. The use of historical data for location differentials and quality differentials is flawed. Quantities vary dependent on operations, shut in, well problems, etc. The actual quality of oil production varies from month to month. Historical data from the preceding year cannot possibly accurately measure quality for a current month's production. That is why the MMS's own Gulf of Mexico Regional Office requires periodic testing for quality at the lease for royalty determination purposes. Therefore, any adjustment for quality to an aggregation point based on historical data is fatally flawed. The comments previously filed by Shell on the flawed approach to location differential, quality adjustment and transportation remain equally applicable to the amended use of Platts index for the Gulf of Mexico. MMS continues to ignore the fact that there is a required additional adjustment needed between an index value (even after it has been adjusted for transportation, quality and location) and a value at the lease. This adjustment is sometimes called a marketing adjustment and it reflects the costs and risks incurred to add value away from a lease.

Attached are detailed comments on the specific provisions of each of the proposed regulations. If the MMS intends to implement this as a final rule, it has provided for no transitory provision to allow lessees to attempt to adjust computer accounting systems to reflect for this dramatically different method of valuing oil for royalty purposes through tracking. A transitory provision of nine (9) to twelve (12) months should be provided as a transitory provision to allow lessees to adapt their existing accounting processes. The comments of the American Petroleum Institute on this proposed rulemaking have been reviewed by Shell and they are adopted herein by reference.

Sincerely yours,

Peter Velez

Peter K. Velez
Regulatory Affairs Manager

Attachment

ATTACHMENT A

INDIVIDUAL COMMENTS ON SPECIFIC PORTIONS OF THE REGULATIONS THEMSELVES

Section 206.101 - Definitions

AFFILIATE - MMS has redefined affiliate to encompass ownership of more than ten percent (10%). Such a restrictive definition is arbitrary and capricious especially if the minority owning party does not have sufficient control to determine officers, board of directors, or policy of the corporation or limited liability company. The present definition of affiliate created a rebuttable presumption of control in ownership below fifty percent (50%). MMS has now eliminated this discretion and has captured within this definition numerous transactions which are actually of opposing economic interest but by definition would be classified as affiliated transactions. Without any factual basis such definition must be characterized as arbitrary and capricious. This definition of affiliate as proposed is ambiguous and unclear in that it does not specify who the "person" to whom the definition applies is. For example, if Shell is in some other business arrangement with another major company unassociated with a particular mineral lease, does that association make Shell and the other company affiliates? Aera Energy is a legal personality made up of Mobil and Shell interests within the State of California. For Gulf of Mexico crude production valuation purposes, this definition of affiliate appears to raise a substantial issue as to whether Mobil and Shell are affiliated companies. Some limiting scope for the definition of affiliate needs to be added to the definition, otherwise it remains arbitrarily vague.

AGGREGATION POINT - Although MMS has provided a definition of aggregation point, its actual selection of aggregation points does not meet this definition. A substantial number of the aggregation points identified by the MMS are not routinely utilized by the oil and gas industry for the kinds of transactions described in the definition itself. Instead, they are merely subsea points at the bottom of the Gulf of Mexico at pipeline interconnects. The definition of aggregation as applied in the transportation regulations fails to recognize that fees charged for pipeline transportation are frequently net from the lease to the shore point. In other words, there is no delineation possible for only a part of the cost of transportation from the platform to the aggregation point selected by the MMS since the aggregation point is not a routine point where business is conducted.

AREA - MMS has continued removal of the phrase "defined limits of" which qualified the description of an oil and gas field. This deletion only further exasperates the ambiguity and lack of definition in the term.

ARM'S LENGTH CONTRACT - The impact of the amended definition of affiliate on arm's length contract is dramatic. The current definition with the ten percent (10%) limitation on definition of affiliate renders many transactions which are obviously at opposing economic interest as non-arm's length. We believe such a definition is arbitrary and capricious and contrary to the way existing law would define an arm's length contract under any reasonable interpretation of law. The failure to define the scope of affiliation under the definition of affiliate renders the definition vague.

EXCHANGE AGREEMENT - MMS has continued the addition of a new definition to define and describe exchange agreements. The definition no longer specifically excludes exchange agreements whose principal purpose is transportation. In fact, the definition appears to now include such arrangements. The definition as proposed is overly broad. The fact that one enters into an exchange agreement away from the lease after a purchase at the lease or after a purchase away from the lease is irrelevant to the determination of royalty value at the lease itself. The definition of exchange agreement should be limited to those having impact or origin "at the lease". Exchange agreements occurring at market centers such as St. James and Empire or at refinery gate are irrelevant to the determination of value of oil at the lease itself. These agreements are made based on commingled production which is no longer identifiable at the single lease for royalty purposes and which reflect market conditions not associated with severance at the time of production at the lease.

GATHERING - MMS has continued to define gathering as movement to a central accumulation point. It fails to address the physical and technological advances made in offshore production where gathering and transportation are important elements. Subsea production moves great distances such as 40 to 60 miles subsea directly to a production platform. To arbitrarily classify such movements at great distance based solely on movement to a central point with no deference given to distance is arbitrary and capricious and contrary to the established definition of transportation under oil and gas law. Production from a tension leg platform may be moved great distances (60 to 80 miles) to a platform on the shallow shelf where royalty settlement is to be determined. This movement can only be classified as transportation.

GROSS PROCEEDS - The definition proposed for gross proceeds is defective since it fails to recognize that the payment of royalty based on the index value specified in the regulations is equivalent to gross proceeds. The definition of gross proceeds should clearly state that a correct payment by a lessee of index value satisfies all gross proceeds requirements. Interior has made a substantial shift in the change of meaning of gross proceeds through the elimination of the phrase "to the oil and gas lessee" so that gross proceeds is defined as "total monies and other considerations accruing for the disposition of oil produced". Under law and regulation and lease term, Interior is entitled only to the proceeds received from the sale by the lessee and not from some subsequent disposition of lease products far removed from the lease by a third party or an affiliated company. This change is unsupported in law and retroactively alters the lease contract which specifically limits proceeds to that received by a lessee. Also changed was the phrase "no cost to the federal lessor". This phrase in the presently existing regulations qualified the value of services performed but only to the extent that the lessee was obligated to perform them at no cost to the federal government. The federal lessor is not entitled to receive the added value of any and all services performed by the lessee away from the lease free of charge. The lessee's sole obligation to the lessor is to place the hydrocarbon in pipeline quality. Costs incurred beyond that, and away from the lease particularly, must be borne by both the lessor and the lessee. Even the cost of placing the production in marketable condition under some circumstances can be associated with the joint shared responsibility of transportation. As drafted, this definition grossly overstates the obligation of the lessee. At its furtherest point of absurdity, the rule requires a higher valuation for deficient product then the value of a high quality product originally produced from the lease. Such disparity results from the high cost of placing the product in what MMS has termed a marketable condition. Such an interpretation which makes poor quality oil more valuable is not only illogical but is unlawful.

MMS has added in the definition of "gross proceeds" a requirement to pay royalty on payments made to reduce or buy down the purchase price of future production by allocating such payments over the production whose price the payment reduces and including amounts as proceeds for the production as it occurs. This provision is no more than a restatement of the MMS's gas contracts policy for collection of royalties which was the subject of a lawsuit in the District of Columbia federal court entitled *IPAA v. Babbitt*. The court in that proceeding specifically directed the MMS to cease collecting royalty on both buy out as well as buy downs. Therefore, the final version of the regulations should eliminate this provision. The provision if retained is impossible to apply especially when leases have been sold or disposed of over a period of time. For example, do payments made to Lessee A in 1998 to reduce the price mean that if Lessee B subsequently acquires the lease, Lessee B becomes obligated for the payment of these royalties associated with that production?

INDEX PRICING - The use of a future price for present day production is inconsistent with the lessee's obligation under currently existing law to pay the value of production at the time physically severed from the lease. Future prices are merely a guess at what a hydrocarbon product may be worth at a specified market location in the future. It may or may not have any relationship to the value of the product at the time it is physically severed at the lease location.

LOCATION DIFFERENTIAL - The definition of location differential describes only the value differences for oil at two different points. It does not explain the difference between location differential and transportation. Nor does it include a provision for a market adjustment to recognize the shift of risks occasioned by the use of an index at St. James and Empire. In practical application, location differential includes not only an element involving an increase or decrease of value occasioned by physical location, but it also includes differences in value associated with particular market conditions in effect at the time the location differential applies. These conditions include not only geographic location but conditions of political instability in the Middle East or other important oil producing areas; over/under supply of a particular type of crude in a particularly geographic location; hurricanes; particular refinery needs; inventory costs; scheduling costs; accounting/overhead costs associated with transportation; ultimate positive or negative affects of blending, etc. This adjustment which we call an index adjustment must occur when value is determined away from the lease, otherwise it is not reflective of value at the lease.

PERSON - The definition of person fails to include a limited liability company which is one of the more common forms for forming of artificial persons used for today's business purposes.

PROCESSING - The MMS has dropped the definition of processing which was included in the 1988 regulations. This definition should be restored. Condensate royalty is to be determined on the basis of oil regulation. In §202.100(a), condensate in described as "that condensate separated from gas without processing". Removal of the definition of processing from the oil regulations would be inconsistent with §202.100(a). In addition, there should be some positive statement made in the definition of condensate which captures the concept of §202.100(a) so that both the MMS as well as its auditors are clearly keyed to the concept that royalty on condensate separated without processing is to be paid on the basis of oil. The MMS proposal must also be revised to provide a direction on how condensate recovered at gas pipelines is to be valued as oil. These directions must include allowance instructions for condensate royalty as well.

QUALITY DIFFERENTIAL - The definition of quality differential is inadequate to describe its use in the regulations. In the regulations, quality differential is used to describe the difference in value between the same oil at different points. Limiting its application to two oils is insufficient to describe its function in the regulations.

TRANSPORTATION ALLOWANCE - The definition of transportation allowance resembles the definition included in the prior regulations. The definition specifically excludes all gathering costs. This definition no longer adequately describes the impact of technology on the production of oil and gas in the deepwater of the Gulf of Mexico. It is arbitrary and capricious and contrary to law for the federal lessor to deny transportation costs associated with subsea production brought great distances to shore as gathering by classifying them as gathering. Movement of this production 40, 60, 90 miles involves transportation and should be recognized as such in the final regulations. It is also arbitrary and capricious to classify the movement of pipeline quality production as gathering when it is moved great distances from a deepwater surface location to a shelf jump off point merely because the royalty settlement point is located on the shelf miles distant from the deepwater lease.

SECTION 206.102

This provision addresses royalty valuation for arm's-length contracts. The rule devotes little effort to telling the lessee what to do with arm's-length contracts other than adopting an expansive rule of "gross proceeds" as total consideration received whether received by a lessee or affiliate. Instead, the rule spends one and one-half columns worth of Federal Register space describing exceptions to arm's-length. The rule requires that the lessee (including all affiliates of the lessee) net back from the first arm's-length transaction no matter how many sales, transfers or exchanges have taken place. No explanation is provided on how such value is related to the value of production at the lease. This provision ignores the statutory mandate to value production at the lease at time it is saved, removed and sold. Nowhere in §206.102 does the MMS explain how oil would be valued if part of a stream, particularly a deepwater stream, when partially sold at arm's-length and partially to an affiliated refiner. If there are differences between the two prices, will one raise or lower the royalty due on the other? The rule also fails to distinguish between oil in different fields or areas. Are all arm's-length sales to be volume weighted averaged or only those in the same field or area?

SECTION 206.116

MMS purports to require an affiliate to fill out forms and render reports to the MMS beyond a first sale of the hydrocarbon. There's no statutory authority for the MMS to require a non-lessee to file reports relative to lease production. In many instances, lessees may not be able to secure such information from affiliated companies who are common carrier pipelines due to FERC restrictions on disclosure of information.

SECTION 206.117

The deficiencies of the Form MMS 2014 were pointed out in Shell's earlier-filed comments. MMS continues to require non-lessees to submit data without statutory authority. MMS also imposes an obligation on lessees to report on data which they are incapable of obtaining because of other federal regulatory requirements promulgated by the FERC. If MMS is to use Form 4415 data it should be regarded as an estimate and MMS should be required to pay interest if the estimate understates value under the provisions RSFA. In other words, in past regulations the MMS has recognized the use of estimated transportation allowances but has also recognized the requirement to adjust retroactively the estimates to actual costs. This would require both lessee and lessor continuously to correct retroactively for transportation allowance based on actual cost for the current year. This is the only process and procedure which would accurately reflect transportation costs in the year in which they were incurred. To do otherwise inherently would render the proposed regulation unlawful, arbitrary, and capricious. MMS abandoned retroactive corrections of transportation allowances because of the high administrative cost for both the agency and the lessee in making retroactive corrections. This new approach is lawful only if retroactive corrections are made.

SECTION 206.118

MMS continues its approach of refusing to recognize the market adjustments necessary to adjust value between the lease and the index pricing point and/or market center. Merely allowing for transportation, location and quality adjustments does not begin to reflect all of the costs or risks assumed by the downstream party, nor the inherent differences in the character and nature of the lease and trading markets. MMS's failure to allow for this adjustment overstates royalty in violation of the royalty clause of the lease and is without statutory or regulatory bases.