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March 18, 1996

Attn: David S. Guzy
Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
Denver Federal Center, Building 85
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

ORIGINAL

RE: Advance Notice of Proposed Rule
Valuation of Oil from Federal and Indian Leases
60 Federal Register 65610, dated December 20, 1995

Dear Mr. Guzy:

The State and Tribal Royalty Audit Committee (STRAC) welcomes the opportunity to submit the following comments on the Minerals Management Service's (MMS) Advanced Notice of Proposed Rulemaking (Notice) on crude oil valuation for federal and Indian royalty purposes.

In its Notice, MMS requests input on potential alternatives to posted prices for purposes of valuing federal and Indian crude oil. STRAC has developed and provides the following detailed discussion on a comprehensive course of action for MMS to take should MMS concur with STRAC that oil marketing has changed significantly since oil valuation rules were last promulgated. In short, STRAC recommends a three-prong approach in addressing problems with federal and Indian royalty oil valuation: 1) that MMS immediately develop policy procedures and guidance which address treatment of buy/sell arrangements or exchange agreements; 2) that MMS then adopt an interim rule that deletes references to posted prices; and 3) finally, that MMS conduct comprehensive studies of the crude oil marketing environment and implement permanent reform of the oil valuation regulations.

The need for a change to MMS's current valuation regulations is clear. At its most recent Quarterly meeting in Denver on February 29, 1996, STRAC was presented with

convincing evidence that posted prices no longer reflect the market price for crude oil in the United States. In summary, we learned that beginning in the mid-1980s, futures trading and general price volatility stimulated the market price for crude oil. Spot prices for crude are and have been consistently above the prices posted by industry in the field. Sales and trades of crude oil have not been made on the basis of posted prices. During this time period the disparity between postings and spot prices has been as high as \$4.00 a barrel. The evidence presented to STRAC at its meeting is consistent with the findings revealed through reviews conducted by many auditors from STRAC jurisdictions, who have uncovered instances of "bonus" prices over the posting. It is also consistent with the actions of some in industry who have come forward to make adjustments to royalty payments, which initially had been paid based on posted prices.

Indeed, it appears that the only remaining use of posted prices by industry is for the calculation of royalties owed federal, Indian, State and private lessors. Conservative estimates of unpaid royalties for federal onshore and offshore leases east of the Rockies show that from 1988 to 1993, the government could lose over \$300 million (without interest) if it does not take steps towards collection.

STRAC believes that much of this loss is recoverable under MMS's current regulations. This is not to say that regulatory reform of those regulations is not needed. MMS's current regulations place obstacles in the path of efficient collection of the true value of federal and Indian production. Although it is the federal and Indian lessees' responsibility to justify the basis for its royalty payments, the reality is that, because of the MMS's benchmark system, the burden has become the government's to disprove a lessee's selected price in order to collect the proper amount of royalties due.

One clear obstacle is, of course, the explicit references to posted price as a factor for valuing federal and Indian production under the MMS benchmark system. Based on the evidence summarized above and the losses attributable to the practice of reporting and paying royalty on the basis of posted prices, STRAC urges MMS to take any available means to quickly rid its regulations of provisions and arguable interpretations that result in overuse of posted prices for valuation.

STRAC urges that MMS proceed at three levels in its effort to deal with the irrelevancy of the posted price system.

1. Policy Guidance

STRAC recommends that MMS issue a formal policy statement immediately on the treatment of buy/sell arrangements under current regulations. This would be in conjunction with a policy statement on application of the gross proceeds methodology.

A vast amount of crude oil is traded through exchanges and reciprocal buy/sell agreements. As the speakers at the recent STRAC meeting underscored, the price

terms under such arrangements are neutral or irrelevant to the trade. In more technical terms, the parties to those arrangements are not operating with opposing economic interests with regard to establishment of the price terms – they are not operating at arm's length. Rather, what one party "loses" in market value by delivering its crude oil at the posted price, it regains by paying less than value for the oil it receives. Neither party has the incentive to obtain as much money as it can for its crude oil. See e.g., Cities Service Oil and Gas Corp., MMS-86-0538-O&G (June 12, 1987). This reciprocal undervaluation serves as an incentive to keep postings lower than market value and masks the value the parties would otherwise place on their crude oil if sold in an outright purchase and sale arrangement.

These agreements should be treated by MMS for what they are. In reality they are the equivalent of the traditional barrel for barrel exchange – not a sale of crude oil. Currently, any "arm's length" negotiation under such arrangements is focused on transportation, not crude price.

The treatment of buy/sell arrangements is not specifically addressed under current MMS regulations. With regard to buy/sell agreements, it is STRAC's position that the only reasonable interpretation of current MMS regulations would be that crude oil transferred under such agreements is to be valued under the non-arm's length provisions. For example, because neither side of a buy/sell arrangement reflects the total consideration received by the parties and because the parties trade cannot be substantively viewed as a true sale of production, application of §206.102(a)(2)(ii) and §206.102(c) should permit MMS to capture the true value of the production for royalty purposes, regardless of the stated price terms. The substance of these transactions, not their form, should dictate how buy/sell arrangements are treated under MMS regulations. See e.g., Arco Oil and Gas Co., 87 IBLA 561 (1989). However, it is equally clear that lessees report and pay royalties by applying the stated price terms in their buy/sell agreements. MMS has not issued any clear cut policy interpretation with regard to the treatment of buy/sell agreements under its regulations, and to a certain degree, its informal guidance has been inconsistent.

Thus, there is a clear need to address the treatment of buy/sell agreements specifically as part of MMS's effort to improve its royalty collection program. And, it is equally clear that if MMS's goal is to capture the true value of federal and Indian crude oil in light of the irrelevancy of posted prices, it must provide that crude oil transferred under such agreements is valued under the non-arm's length rules. Such an approach would permit MMS to value such production on the basis of the consideration actually received under outright purchase and sales arrangements (§§206.102(c)(1) – 206.102(c)(3)), or, in the absence of significant quantities or comparability, on the basis of spot prices. §206.102(c)(4). By taking buy/sells out of the arm's length rule, it should also enable MMS to ascribe, in many if not most instances, truer values under the benchmarks to intra-corporate transfers.

Thus, STRAC recommends that MMS issue immediate policy guidance on the treatment of buy/sell arrangements under its current rules. Such a policy should also be incorporated specifically into any final rules change.

2. Interim Regulations

As an interim measure, STRAC recommends that MMS act quickly to adopt a rule that deletes the references to posted prices in the oil valuation regulations.

The need for immediate action is clear. In the current environment with the likely advent of legislated time restrictions on its program, MMS cannot afford to operate under a system that places obstacles in the path of the efficient collection of the true value for royalty purposes.

At the same time, STRAC strongly believes that MMS does not have ready access to the type of information needed to promulgate a rule that will have long term utility. The information reported to MMS for royalty purposes overly reflects payments based on posted prices and more generally has not proved reliable. Compliance audits are not an adequate tool to compile the type of information that the government would need to make a considered evaluation of pricing and indeed even compliance audits have been limited to a certain extent by MMS regulations and to a greater extent by disputes over document access. While a more flexible rule granting greater discretion to the Secretary to determine value based on all relevant factors would theoretically resolve this information vacuum, the likelihood of greater legislative restrictions on the government's ability to account and collect royalties discounts the viability of such an option. STRAC, at this time, also opposes the use of regulatory negotiation as a means to fill the information void. STRAC's experience as participants in the gas "reg-neg" leads it to conclude that such an approach permits industry to control the debate because of its exclusive access to necessary information.

Thus, STRAC recommends that, as an interim measure, MMS adopt a new rule for valuation of crude oil transferred under non-arm's length agreements based on spot prices at Midland and Cushing. While STRAC as a whole is not convinced that these prices will capture the true value of crude oil produced in the various regions of the United States, these prices are used by the industry in a substantial number of transactions involving the sale or trade of crude oil.¹ Currently, there is no reason to

¹ STRAC is aware that the California State Controller's Office, which has membership in STRAC, has recommended a different alternative for valuation of crude oil produced within and offshore that State. STRAC's proposal should not be interpreted as a disagreement with that proposal. STRAC's recommendation on the interim use of spot market prices at Cushing and Midland, thus, does not extend to valuation of crude oil produced in or offshore California. STRAC understands that the State Controller's Office shares its concerns that there are problems with MMS's current regulations that transcend the posted price issue and with the absence of reliable information upon which to promulgate a rule of long term utility.

believe that these prices are not truly market determined and the nature of the spot market provides some degree of protection against manipulation or undervaluation over a longer term. Thus, use of these spot prices in the interim should at least enable MMS to capture as royalty an amount that more truly represents a market price in a manner that is less burdensome than under current regulations.

STRAC recognizes that use of these prices will require quality adjustments and that MMS will feel compelled to provide a location differential. STRAC is not prepared at this time to recommend a specific means for calculating these adjustments. Generally, however, it is STRAC's position that any means for calculating quality adjustments should give MMS sufficient flexibility to assure that gravity and sulfur banks used reflect real economic values.

Similarly, STRAC would support a realistic location differential. Such a differential should be directed at capturing the relative value to refineries of different crudes in light of their location and not at reimbursement to lessees of their transportation costs. While STRAC believes that a reasonable method or formula for determining location differentials can be found, it is again concerned that MMS does not have the type of information available upon which to make such a determination. This is due to the following: 1) audits of transportation systems have not been uniform or widespread; 2) auditors have not been permitted to review relevant downstream information, including refinery values; 3) MMS regulations overly rely on tariffs even for non-arm's length transfers²; and 4) there has been consistent misreporting of transportation data by industry. Conducting the type of review necessary to maximize the accuracy of any location differential would, however, substantially delay reforms that are needed now. Thus, at least for the interim, STRAC would not recommend any change to MMS's current regulations except those noted.

Finally, as part of an interim rule, MMS should specifically address the scope of government audits by providing that such audits are not limited or governed by the valuation regulations. This should include a provision reaffirming the right of MMS auditors to obtain information from parties other than lessees and the right of access to all information downstream from the lease to the first arm's-length sale or through and including values internally placed on crude oil at the refinery gate, if necessary.

² As at least one speaker at STRAC's recent Quarterly underscored, tariffs for pipeline transportation have rarely, if ever, been subject to critical review by the government. Reliance on such tariffs in non-arm's length situations and especially to determine value under STRAC's proposed alternative is suspect. Indeed, random reviews have shown that certain tariffs substantially exceed the location differentials used by industry in reciprocal buy/sell arrangements, which suggests that tariffs are of little relevance to determine the relative values of crude oil to refineries due to location. STRAC thus agrees with the position of the California State Controller's Office that MMS should delete §206.105(b)(5) as part of its effort to reform the crude oil valuation regulations.

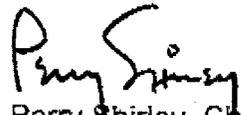
3. Well-grounded Permanent Reform

STRAC recommends that MMS begin now to work towards a more comprehensive reform of the crude oil valuation regulations. MMS needs to work towards developing an approach to valuation that will better reflect and respond to market prices. MMS's reliance on posted prices demonstrates the risk posed by failing to take a hard look at industry pricing practices. While to a certain extent the government will always be in a "catch up" position, the risk of loss will be reduced if MMS puts itself in a position where it can more readily detect and react to market changes.

STRAC recommends that MMS expand its audit approach to include not only compliance with regulations but investigations of industry pricing practices. Audit should be viewed not only as a collection tool, but as a tool for compiling the objective information needed for MMS to meet its statutory mandates. In order for comprehensive regulatory reform to move forward more quickly, STRAC further recommends that MMS retain independent consultants to review the crude oil market and provide recommendations with regard to the establishment of benchmarks for royalty valuation purposes. MMS would also benefit from use of consultants to the extent that they could assist in the development of cost effective investigatory audit plans.

STRAC is available to assist MMS in carrying out the recommendations provided above. If you have any questions, please contact one of the STRAC officers listed in the letterhead.

Sincerely,


Perry Shirley, Chair
STRAC

cc: STRAC Membership