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July 30, 1998

Mr. David S. Guzy
Chief, Rules and Publications Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3021
Denver, CO 80225-0165

Dear Mr. Guzy:

RE: MMS Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, 63 Fed Reg. 38355 (July 16, 1998)

Conoco Inc. ("Conoco") welcomes this opportunity to submit the enclosed comments to the Minerals Management Service ("MMS") with respect to the above referenced Proposed Rule.

Conoco is a wholly owned subsidiary of E.I. DuPont de Nemours and Company. In 1997, its worldwide production of crude oil, condensate, and natural gas liquids averaged 374,000 barrels per day and its worldwide natural gas production averaged 1,210 million cubic feet per day. During the five-year period ending December 31, 1997, Conoco remitted royalty payments to the MMS in excess of $408 million.

Conoco further adopts by reference and hereby incorporates the comments filed on behalf of the Independent Petroleum Association of America, the American Petroleum Institute, and the Barents Group report entitled "Analysis of The Department of Interior, Minerals Management Services Further Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases."

Thank you for the opportunity to comment on this matter. If you have any questions, please contact me at (580) 767-5044.

Sincerely,

John E. Clark

Lt
Enc

cc:
R. C. Harvey, Houston
R. R. Fritz, Houston

Comments of Conoco Inc.
Regarding the Department of Interior
Minerals Management Service Proposed Regulations
30 CFR Part 206
Establishing Oil Value for Royalty Due on Federal Leases

Further Supplementary Proposed Rule
Appearing in the Federal Register July 16, 1998

The MMS has, once again, supplemented their proposed rule for *Establishing Oil Value for Royalty Due on Federal Leases*, which was issued in the Federal Register on July 16, 1998. Comments were requested on or before July 24, 1998, but then extended to July 31, 1998.

Essentially, the MMS has made relatively minor modifications to the Supplemental Proposed Rule and has not made modifications that would render the proposed regulations to be fair or reasonable. The MMS has reverted back to the 1988 regulations in their definition of what constitutes an "affiliate". This is an issue that does not affect Conoco Inc. ("Conoco") because Conoco does not have a crude oil marketing affiliate. Thus, regardless of the definition of the term "affiliate," Conoco will continue to be burdened with an unfair and unreasonable "index" scheme to value federal royalty oil as proposed by the MMS. Additionally, Conoco does not qualify under the MMS' flawed "tendering" scheme designed for the Rocky Mountain region solely because Conoco has its own "tendering" program and therefore will be forced to use the "index" scheme for federal oil produced in the Rockies.

Conoco continues to object to the proposed regulations even after they have been modified in this Further Supplemental Proposed Rule ("Proposal"). For all the reasons previously submitted to the MMS by Conoco, both in comment form and in oral comments at the MMS "public meetings," the proposed rule remains unfair and totally unreasonable. The MMS action as noticed in the July 16, 1998 Federal Register has done nothing to improve on the fairness nor reasonableness of the Proposal. The Proposal continues to ***mandate*** an indexing scheme for areas east and south of the Rocky Mountains that is fraught with horrendously burdensome administrative and record keeping requirements. Additionally the subjective standards and criteria imbedded in the MMS "indexing" scheme will ultimately be determined at the sole discretion of the MMS or after protracted audits and appeals that will occur years after royalties are valued and paid.

The Proposal undermines completely 3 of the 4 stated intents of the rule making effort: (1) to reflect true market value at the lease; (2) provide certainty to all involved; and (3) provide maximum flexibility to adapt to changing market conditions. Regarding the 4th stated intent, "to reduce reliance on posted prices for royalty valuation," the MMS achieves its objective. However, this objective is flawed and lacks in foundation an understanding of regional lease (wellhead) arm's-length markets that are based on posted prices. It also totally ignores the fact that active and vibrant markets exist at the lease within a range of value most of which are based on posted prices, as evidenced by a mountain of evidence. In its objective to "reduce reliance on posted prices," which are generally found in tendering methodologies, the MMS rejects tendering for any area outside the Rocky Mountain region. For most other areas, excluding California, proposing proxies ("indexing") embodying a scheme requiring a series of assumptions and adjustments (assuming one size fits all) and requiring agreements on dozens of variables (each with a range of value or cost) will guarantee many more points of probable disagreement, uncertainty, and inevitable litigation. Just because the MMS does not understand the proper role of posted prices in lease valuation that is no justification to do away with them entirely.

The MMS should first seek to understand how regional lease markets work, including the role (past and present) that posted prices play. The MMS should investigate fully various methods of establishing fair value at the lease before discarding them and advancing, in their stead, methods that reach beyond the contractual privity of its lease without defining any point along the market stream beyond which the MMS will not reach for enhanced value. Conoco maintains that if efforts were made to understand this part of the business, MMS would find far easier and fairer ways to establish fair market value for royalty purposes than the current Proposal.

Conoco's Competitive Bid ("Tendering") Program

There are several ways to assess the ***true value at the lease***. Of course sale of lease production under an arm's-length transaction should be accepted without question. Conoco designed a ***competitive bid program*** (called a "tendering" program by the MMS) as a means to identify arm's-length transactional value ***at the lease*** for valuing all its equity and associated lease production including federal royalty oil. Conoco believes this program is both fair and reasonable and should be an acceptable alternative method to value federal royalty oil ***at the lease*** and it has been endorsed by API, IPAA, DPC, RMOGA, and COPAS. The MMS seems to recognize that a competitive bid program will reveal value at the lease inasmuch as they have incorporated this lease value method (albeit flawed) for the Rocky Mountain region. Indeed, throughout the Federal, State and Local government structure, competitive bidding is more than commonplace. However, the MMS rejects competitive bidding outside of the Rocky Mountain region because they believe that their indexing scheme is a better indicator of market value. Conoco and many others have commented in over 4,000 pages of comments why this belief is misguided. However, the MMS appears unmoved by these copious comments and seemingly chooses to ignore the fact that a ***real and active market*** exists ***at the lease.*** The Proposal is bad public policy and Conoco remains opposed to the Proposal and will continue to do so until the MMS proposes and adopts a realistic and workable regulation, including a tendering option, for establishing value for royalty oil **on federal leases.**

In September, 1997 Conoco offered to explain in detail to the MMS our competitive bid program and why we think this is a lease value methodology that is both fair and reasonable. The MMS has ***never*** accepted Conoco's offer. We explained our program, in general terms, at workshops held by the MMS and even provided the MMS with bid solicitation letters and bid specifications at the April 17, 1997 "public meeting" in Houston, Texas. During the workshops most of the oil producing states attending (including New Mexico and Louisiana) agreed that a competitive bid program would be acceptable to them (depending on the structure of the program). Conoco offered to share with the MMS its bid packages, bid evaluations and other parts of our program to demonstrate to the MMS that Conoco's competitive bid program is both fair and reasonable to all leaseholders including the federal government. However, the MMS only relayed "concerns" coming out of Washington D.C. that the government could somehow be "gamed" by such a program. Nevertheless Conoco's offer to explain its competitive bid program remains open to the MMS and we encourage the MMS to call (281) 293-1683 to arrange for a time and place for us to present and explain our program. We would think it obvious that an arm of the federal government entrusted with the implicit mandate to adopt rules and regulations consistent with good public policy would at the very least demonstrate good faith efforts at "seeking to understand" the potential benefits and concerns, if any, of a bona fide tendering program that has been in existence for almost 18 months. Conoco holds firm in its position that a competitive bid program should be an option available to lessees.

Conoco would also like to point to the fact that our competitive bid program is in many respects similar to the program the MMS has recently unveiled to market its R-I-K barrels under the MMS Pilot R-I-K program in Wyoming. Conoco is puzzled that a tendering program run by the MMS is fair and reasonable but a tendering program run by lessees is not fair and reasonable.

MMS Stated Concerns with Tendering

The following concerns with a tendering program were posted on the MMS web site on July 24, 1998. The MMS was requested by certain Senators to respond to a list of six primary problems industry has to the MMS Proposal. Conoco has quoted each of the six concerns of the MMS relating to tendering and its reply to each concern.

MMS Concern # 1.

"Tendering is an artificially-created market for the purpose of paying royalties. It does not represent how companies actually market their production and accordingly cannot represent market value. If there truly were an active, transparent, and competitive market at the lease, there would be no reason to establish a tendering program."

> **Conoco's Response:** This concern of the MMS illustrates our point. The MMS does not know this part of our industry and the MMS is completely wrong. Tendering is not an "artificially-created" market. It is a means to determine what the true arm's-length market value truly is at the lease. If two or more non-affiliated bidders bid on lease crude then those bids are true representations of that lease oil market value. Tendering discloses the transparent and true market value at the lease. Without question an audit would easily disclose this fact. What the MMS is really saying is that lease market values are not publicly reported which is true. But that does not mean that a lease market does not exist. Nor does it mean that lease values are somehow disguised from the MMS. Rather they are available and transparent to any observer of a bid opening process or subsequent audit. Indeed Professor Joseph P. Kalt in his study (described in his comments of May 26, 1997) found a very active and competitive market at the lease.

Furthermore, the spot prices that the MMS wants to rely on are journalist's impressions of market value based on a series of telephone calls made to a few traders. They may or may not represent ***actual*** deals. Additionally, the volume of barrels supposedly traded is completely unknown. Conoco's competitive bid program use actual offers to buy crude and not hearsay.

MMS Concern #2. "Tendering is not a legitimate measure of market value where it involves only small volumes of production from company-selected properties that would be used to value large volumes of production sold to an affiliate and either resold or refined."

Conoco's Response: Conoco agrees that in some instances offering a small volume of production may produce values that would be different versus selling larger quantities of production. Indeed Conoco began its program by offering relative small qualities of production (10%) but found that "high" bid prices were also volume limited. To achieve a more representative lease value Conoco began to offer 100% of our available production. (We essentially offer 100% of our equity and associated production under our program of which only about 4% represent Federal royalty oil not taken in-kind by the MMS. Conoco's intent is to sell a minimum of 10%.)

MMS Concern #3. "Tendering is a more administratively burdensome means than index prices for valuing production not sold at arm's-length. Spot prices play a major role in crude oil marketing and are readily available through price reporting services."

Conoco's Response: This concern is another example illustrating that the MMS does not understand the complexity of the business they are trying to improve. Conoco totally disagrees with the MMS that "tendering" is more administratively burdensome than indexing. Conoco has almost 18 months experience with its competitive bid program administered without developing new and complicated systems and record keeping and believes that the MMS would find it much easier to administer. Under such programs the MMS would know up to six months in advance what prices to expect. All the MMS would have to do is track certain posting companies price bulletins and adjust with the premium or discount offered by the highest bidder. The MMS' concern completely ignores the uncertainty provided by leaving subjective standards of reasonableness up to the sole discretion of the MMS well after the fact and probably after years of audit. Furthermore the Proposal would require retention of a whole new universe of records that is administratively horrendously burdensome and involves contracting parties well beyond the wellhead, including third parties and third party affiliates whose records are not accessible or legally available.

MMS Tendering Transportation Concerns

The MMS went further in its response to industry's issues and listed three concerns that the MMS has with "tendering" as it relates to transportation. Its concerns and Conoco's responses to those concerns follow.

MMS Transportation Concern #1

"Tendering does not solve the transportation issue. When a purchaser bids on tendered volumes, it must take into account the costs of transporting production away from the lease. In most cases, the purchaser will have to transport that production through a pipeline owned by the lessee and pay tariff rates that are not reviewed by FERC to assure that they are just and reasonable. A purchaser of such crude will often have to negotiate carriage rates on proprietary pipelines off the lease. A captive marketplace can result. Therefore, the price bid by the purchaser and used by the lessee to compute its royalty obligation will necessarily be discounted to reflect these lessee-established tariff rates."

Conoco's Response: Without a doubt, bidders under a tendering program will evaluate their cost to transport crude off a lease in determining what price to bid. Each bidder is free to determine what this cost will be to them. Conoco is unaware of any instance where its bidders have had to "negotiate carriage rates on proprietary pipelines off the lease." We do not think this is a valid concern for the MMS. With the exception of offshore production, all Conoco onshore pipeline connected production is connected to either an interstate or intrastate common carrier pipeline whose rates are regulated by some government entity. In several areas, federal and Indian production associated with Conoco equity production is connected to another company's pipeline. In several instances the owner of these pipelines rendered the highest bid on offered barrels because they apparently elected to forego some of their pipeline profit to acquire needed oil. This is an advantage of the tendering program versus the MMS index scheme and not a disadvantage as portrayed by the MMS.

MMS Transportation Concern #2

"Under the OCSLA, offshore lessees are required to pay royalties on the 'production saved, removed, or sold' and 'production' is defined to include the 'transfer of minerals to shore.' Therefore, tendering at the lease offshore will not reflect the legal requirements of lessees to transfer minerals to shore."

Conoco's Response: A tendering program for offshore production does not have to be "at the lease" to be valid. Conoco designed its program to offer offshore production at the point closest to the lease where bidders have access to common carrier transportation systems. This was done to ensure active bidding. These arm's-length values are then adjusted using the MMS allowable transportation deductions, if any, to arrive at the value of the production at the lease. Thus MMS enjoys a true arm's-length value with only MMS allowed transportation deductions taken into account.

MMS Transportation Concern #3

"Under existing tendering programs, companies do not tender production from every lease in a particular field or area, but use the price received from those leases from which they do tender to value production sold to an affiliate from all of their leases in a field or area. For those leases from which they do not tender production, they must make transportation adjustments to the tendered-price to arrive at the value of production from those leases."

Conoco's Response: Conoco does not have an affiliate that markets lease crude oil. That said, Conoco agrees with the MMS that we do not tender production from each lease. Conoco has thousands of leases and it would be administratively impractical to tender them one by one. However, Conoco does use representative leases or units and offers production from these under four basic categories: (1) sweet, (2) sour, (3) pipeline connected or (4) trucked. Very few barrels under Conoco's competitive bid program require a transportation adjustment, which appears to be the concern of the MMS. Conoco has developed its program to capture as many of the 4 unique characteristics as described above in the field where production occurs. Additionally, Conoco management reviews the program at least annually to validate that there is a fair representation of lease value in the resulting bids. Adjustments are made, if necessary, to maintain fairness to all owners of interest.

The MMS response to industry on July 24, 1998 regarding tendering is perplexing to Conoco because Conoco has not been afforded the opportunity to explain in detail and answer questions of the MMS regarding our very successful program. Conoco asked Dr. Kalt to review and critique Conoco's competitive bid program in January of this year after it had been implemented for 9 months to get a petroleum economist's perspective of how the program has evolved since it was first implemented and to validate that the program does, in fact, reveal fair market value at the lease. Dr. Kalt's report is attached for reference.

"**Second Guessing" Preamble Comment**

Lessees continue to have a concern that the MMS will "second-guess" a lessee's marketing decision even when sales are made under arm's-length transactions. This concern remains despite the fact that the MMS states what they will and will not do in the Preamble to the Proposal. Specifically, MMS statements in the Preamble do not have the force of regulations nor do the courts consider the Preamble when asked to interpret or enforce the regulations. Furthermore, the MMS has recently demonstrated that they have no compunction of unilaterally enforcing selective provisions of the **regulations** when it is in the government's favor. The continued use of words in the regulations such as "inappropriately sells" ϶ 206.102 (2) (ii) and "reasonable location or quality differentials" ϶206.102 (3) leave the MMS an opportunity to "second-guess" lessee's arm's-length transactions. The MMS must remember that the lessee, in all probability, **sold its own oil**

at the same arm's-length value that the MMS may in hindsight find to be "inappropriate" or "unreasonable". Where is the certainty or fairness for the lessee?

Duty to Market

Conoco position is and has been that any duty to market by the lessee on behalf of the MMS is restricted to the lease. Any marketing downstream of the lease "for the mutual benefit" of both lessee and MMS is ***not free of cost*** to the MMS.

Gathering vs. Transportation

The MMS has solicited comments regarding the appropriateness of allowing a gathering deduction on federal oil produced "from sub-sea production" and transported "over long distances" as a transportation deduction allowance. Development of deepwater fields has evolved due to new and expensive technology. The technology used to develop offshore production in shallower waters is inappropriate in deepwater necessitating different production and handling designs. Platforms as used in shallower waters will, in all probability, not be used in deepwater. Bulk unseparated oil will be produced and immediately transported via sub-sea pipelines to shallower waters where it will surface and be treated on a platform. Assuming that platforms could be economically built in deepwater, the cost of moving the bulk oil via these sub-sea pipelines would routinely be considered as "transportation" under MMS regulations and thus a 'transportation allowance" would be applicable. Conoco's position is that a "transportation allowance" should also be allowed for the sub-sea movement of deepwater oil under the same conditions that would apply if these pipelines were defined as "transportation" under the MMS regulations.

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ROBERT F. OCHS

January 5, 1998

Robert F. Ochs, Esq.
Legal Department
Conoco, Inc.
P.O. Box 4783
Houston, Texas 77210-4783

Dear Mr. Ochs:

You have asked me to review Conoco's "bid-out" program by which certain of Conoco's interests in domestic crude oil production are put up for sale through a public bidding program. In particular, you have asked me to evaluate whether and to what extent the bid-out program can be relied upon to yield accurate measures of the market value of the oil at the lease. I have discussed the design and implementation of the program with Conoco personnel. I have also learned about the operation and outcomes of the program during its first few months of activities.

Conoco's bid-out program is one by which Conoco solicits bids from unrelated parties to purchase some or all of its crude oil production in various producing regions. For each producing area that participates in the program, Conoco offers ten percent of Conoco's production volume for sale. For many areas, bidders, at their option, may bid for any amount between ten percent and all of Conoco's crude oil production. Any sale that occurs under the program is an outright cash sale under standard terms and conditions. The term of the sale is for six months; the bid price is established as a premium or deduction from a relevant posting, generally Koch's. Bids are solicited from numerous (over 20) bidders. Conoco reserves the right to reject all bids; otherwise it sells the oil at the highest qualified bid price.

Basic economic reasoning leads to the conclusion that the best indication of fair market value is outright cash transactions between reasonably informed, unrelated parties with adverse interests in the transaction. Based on my understanding of the design and operation of

Conoco's bid-out program, the bid prices revealed will generate a reliable measure of the fair market value of Conoco's crude at the lease or in the field.

The design and implementation of the bid-out program clearly meets the economic criteria for achieving fair market value.

- Conoco provides appropriate information to all interested, qualified bidders and has itself solicited bids from potentially interested bidders. Where Conoco has applied its program, there appears to be an active and competitive market for crude at the lease or in the field as demonstrated by the number of potential and actual bidders. This is consistent with the overall structure of the domestic crude market in which there is active competition to purchase crude in the field. No particular number of actual bids, however, is required for the program to provide a reliable measure of market value. It is only required that the bidding process give effect to the forces of supply and demand that jointly determine fair market value. Based on my understanding, the Conoco program clearly meets this standard.

- Offering for bid ten percent of Conoco's volume in any given producing area is, in general, more than adequate for market forces to reveal fair market value of the crude. There is no need for the percentage to bear any relation to Conoco's royalty or working interest obligations in the area. The design of the program provides the opportunity for market forces, as expressed in arm's-length bids, to operate.

- Conoco's right to refuse to sell some or all of the crude and instead exercise the implicit option economically to purchase the crude for itself does not invalidate the high bid price as a measure of fair market value. As long as there is a reasonable expectation on the part of bidders that some amount of crude will be sold in a significant portion of the bids, bidders will have the incentive to analyze the offer and prepare bids consistent with their objectives and their understanding of market conditions.

- The terms of the bid -- the standard terms and conditions, the six month term and pricing basis as a premium or deduction off of the relevant Koch or other postings -- are consistent with marketing practices in the industry. Consistent with the use of good marketing practices intended to enhance the market value of the crude, rather than marketing 10% of all crude that must be trucked from the lease on a well-by-well basis, Conoco selects some representative wells in an area and offers all of the production from those wells for bid. This method used by Conoco will tend to reduce transaction costs to bidders and result in higher bid prices. To the extent the wells are representative of production in the area, prices under the program will represent fair market value for the crude in the area.

If you have any additional questions or request additional information, please give me a call.

Sincerely yours,

Joseph P. Kalt

Joseph P. Kalt